Ju 11.7/2:1986-384

14 742-B

mf 214

T. C. Memo. 1986-384

ORIGINAL

UNITED STATES TAX COURT

MICHAEL H. SMITH, Petitioner v. COMMISSIONER OF INTERNAL
REVENUE, Respondent

Docket No. 12990-85. Filed August 18, 1986.

Michael H. Smith, pro se.

Janet A. Engel, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, Judge: Respondent determined the following deficiencies in and additions to petitioner's Federal income tax:

Year	Deficiency	Section 6653(b)[1] Addition to tax
1979	$3,183.00	$1,591.50
1980	5,200.75	2,600.38
1981	4,016.00	2,008.00

After respondent's concession that petitioner is not liable for the addition to tax under section 6653(b) with respect to 1979, the issues are (1) whether respondent's motion to dismiss for failure of petitioner properly to prosecute should be granted, and (2) whether petitioner is liable for the addition to tax for fraud under section 6653(b) with respect to 1980 and 1981.

FINDINGS OF FACT

Petitioner, Michael H. Smith, resided in Zion, Ill. when he filed his petition herein.

During all times relevant hereto, petitioner was employed as an electrician by American Motors Corporation ("AMC") in Kenosha, Wisc. Petitioner had commenced his employment with AMC in October 1974. During the taxable years 1974, 1975, 1976, 1977 and 1978, petitioner received wages in the respective amounts of $8,333.64[2] $11,023.08, $12,280.77, $14,820.53, and $17,562.73.

---

[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] This amount consists of wages of $2,026.44 from AMC, for (footnote continued)

Petitioner filed Federal income tax returns for the taxable years 1974 through 1978, inclusive. On each of these returns, petitioner reported his wages as income, reflected his liability for Federal income tax, and claimed a refund for the amount by which Federal income tax withheld from his wages exceeded his reported liability for Federal income tax.

During 1979, 1980 and 1981, petitioner received wages from AMC in the respective amounts of $17,938.87, $24,011.03, and $20,650.52. For 1979, petitioner submitted to the Internal Revenue Service a document purporting to be a Form 1040, Federal income tax return. Thereon, petitioner included his name and address, indicated his filing status as single, and claimed one personal exemption for himself. On the lines provided for reporting various items of income, deductions, and credits, petitioner wrote either "Object" or "None". The form was signed by petitioner under penalties of perjury, and was dated April 14, 1980.[3] For 1980 and 1981, petitioner filed no documents

---

(footnote continued from previous page)
which petitioner had commenced work in October, 1974, and wages of $6,307.20 from Motorola, Inc. of Franklin Park, Ill.

[3] The document submitted by petitioner with respect to 1979 was not accepted for filing by respondent. In this connection, a letter dated June 16, 1980 was sent to petitioner by the director of the Kansas City Service Center, by registered mail, return receipt requested, which provided, in pertinent part, as follows:

> The U.S. Individual Income Tax Return form we received from you for the above year is not acceptable as an income tax return because it does not contain information required by law, and it does not comply

(footnote continued)

purporting to be Federal income tax returns.

When he commenced his employment in 1974, petitioner had filed with AMC a Form W-4 (Employee's Withholding Allowance Certificate) showing his marital status as single and claiming no exemptions for purposes of withholding Federal income tax from his wages. However, on or about February 25, 1980, petitioner filed with AMC a Form W-4 claiming that he was exempt from the withholding of Federal income tax from his wages. On this Form W-4, petitioner claimed that he had incurred no Federal income tax liability for 1979 and expected no Federal income tax liability for 1980. Petitioner signed this form under penalties of perjury. On or about May 15, 1981, petitioner filed a second Form W-4 with AMC, again claiming he was exempt from the withholding of Federal income tax from his wages.[4] On this form,

---

(footnote continued from previous page)

> with Internal Revenue Code requirements.
>
> This is your notice of the legal requirements for filing Federal individual income tax returns. Failure to file a required return may subject you to prosecution under Internal Revenue Code section 7203. The requirements, and an explanation of the penalty, are shown on the back of this letter.

The letter included two blank forms 1040 and an addressed envelope for petitioner's "convenience in filing a proper return." Despite his receipt of this letter, petitioner filed no other document purporting to be a Federal income tax return for 1979.

[4] Together with the Form W-4 filed on May 15, 1981, petitioner also submitted to AMC a document entitled "Notice of Withdrawal of Form W-4 and Determination of Employee Status For Federal Employment Tax Purposes". Therein, petitioner claimed that he was not an "employee" for purposes of Federal employment taxes,

(footnote continued)

petitioner claimed that he had incurred no Federal income tax liability for 1980 and expected no Federal income tax liability for 1981. As a result of the Forms W-4 filed by petitioner on February 25, 1980 and May 15, 1981, AMC ceased withholding Federal income tax from petitioner's wages during the period from February 1980 until June 28, 1981, at which time AMC recommenced withholding pursuant to instructions from the Internal Revenue Service.

Sometime during 1981, after AMC recommenced withholding Federal income tax from petitioner's wages, petitioner sent a letter to AMC's legal department on the letterhead of an organization entitled "Committee for Constitutional Rights" having an address at P. O. Box 139, Somers, Wisc. 53171. This letter provided, in part, as follows:

> It has come to our attention that your company has become involved in numerious personal disputes between workers and the Internal Revenue Service. American Motors [AMC] is disreguarding properly filed w-4 forms and withholding money from workers paychecks in violation of their contract. We would like to point out that anytime a person's property (wages), are taken without his or her permission, over their objections, and without an order from a court of comptant jurisdiction, it amounts to thief, pure and simple....
>
> We insist that from this point on, American Motors refrain from becoming involved in disputes between any government agencies and above mentioned workers, just as you wouldn't involve your company in any other personal matters of your employees.

(footnote continued from previous page)
and purported to give notice to AMC that it was not authorized to withhold any Federal employment taxes from payments made to him. Petitioner attached to this "Notice of Withdrawal" an "Affidavit and Statement of Facts" in support of his contention asserting numerous objections to the Federal income tax and employment tax system.

> In the past, we have had no disputes with your company and we will have none in the future if we can settle this matter amiably. However, if your company persists in these unlawful and unconstitutional practices, we will have to resort to less agreeable methoids. [Errors in original]

The letter was signed by petitioner in his capacity as a "Spokesman" for the "Committee for Constitutional Rights".

In his notice of deficiency dated February 14, 1985, respondent determined that petitioner's wages from AMC of $17,938.87, $24,011.03 and $20,650.52 during 1979, 1980, and 1981, respectively, constituted taxable income. Accordingly, respondent determined a deficiency in petitioner's Federal income tax for each of such years. Respondent also determined that petitioner was liable for the addition to tax for fraud under section 6653(b) with respect to each of the years in issue.

Petitioner filed his petition herein on May 16, 1985.[5]

---

[5] Paragraphs 4 and 5 of the petition provide as follows:

> 4. The determination of tax set forth in the said notice of deficiency is based on the following errors:
> (a) The Commissioner erred in determining that the alleged tax deficiency of the Petitioner for taxable year 1979 is $3,183.00, for taxable year 1980 is $5,200.75 and for taxable year 1981 is $4,016.00.
> (b) The Commissioner erred in determining an interest addition to tax [sic] of Petitioner for taxable years 1979, 1980 and 1981.
>
> 5. The facts upon which petitioner relies as the basis of his case are as follows:
> (a) Petitioner has performed no act and has no knowledge of any fact that denies him the procedural right to a jurisdictional challenge under the Administrative Procedures Act.
> (b) Petitioner has performed no act and has no knowledge of any fact that would grant the Commissioner

(footnote continued)

Respondent filed his answer herein on July 5, 1985. Therein, respondent conceded that petitioner was not liable for the addition to tax under section 6653(b) for 1979, but made affirmative allegations of fact in support of his determination

---

(footnote continued from previous page)
administrative jurisdiction for the issuance of an alleged NOTICE OF DEFICIENCY to Petitioner. (Tax Court Rule 40)

(c) Petitioner has performed no act and has no knowledge of any fact that would require him to enter evidence against himself, when all the accusations and allegations of the NOTICE OF DEFICIENCY are in dispute, since the said allegations and accusations are exclusively based upon the commisioners [sic] determinations of the applicable statutes.

(d) Petitioner has performed no act and has no knowledge of any fact that would sustain the alleged NOTICE OF DEFICIENCY and the penalties and interest accrued therein against the Petitioner.

(e) Petitioner has performed no act and has no knowledge of any fact that would allow the Commissioner to assign the Petitioner an illegal NOTICE OF DEFICIENCY.

(f) That the notice of deficiency (attached hereto) represents a direct tax upon the source, and, as such, is constitutionally impermissable.

(g) That the commissioner has in his possession complete information that would prove that this petitioner has no tax liability.

(h) Petitioner has performed no act and has no knowledge of any fact that would allow the Commissioner to violate the publishing requirements of the Federal Register as detailed in various orders and acts.

(i) Petitioner has performed no act and has no knowledge of any fact that would allow the Commissioner to violate the rulemaking requirements of various orders and acts.

(j) Petitioner has performed no act and has no knowledge of any fact that allows the Commissioner to ignore the requirements in regards to NOTICE concerning the solicitation requirements spelled out in the Privacy Act of 1974 or the Paperwork Reduction Act of 1980.

that petitioner is liable for the addition to tax for fraud under section 6653(b) with respect to 1980 and 1981.[6]

By notice of trial served upon the parties on October 9, 1985, this case was calendared for trial at the March 4, 1986 trial session of this Court in Chicago, Ill. When this case was called for trial on the morning of March 4, 1986, petitioner and counsel for respondent appeared. At that time, the Court asked each party to summarize the relevant issues in the case. Counsel for respondent indicated that the issues were whether petitioner's wages from AMC constituted taxable income and whether petitioner was liable for the addition to tax under section 6653(b) for 1980 and 1981. Petitioner disagreed, however, that such matters were at issue. He replied:

> Your Honor, there is another issue at hand here. As far as the wages, that was not brought up by me. It seems to be an issue she [respondent's counsel] has come up with somewhere. The Matter of Discovery. I have just received yesterday information from [respondent's counsel] that they do not intend to comply with discovery in the matter...

Petitioner insisted that the Court consider the "matter of discovery" and refused to discuss the merits of this case or the substantive matters in issue.[7] Counsel for respondent indicated that she had been served with a document entitled "Request for Production of Documents," and presented a copy thereof to the Court. Therein, petitioner sought, inter alia, production of the following documents:

---

[6] Although petitioner did not file a reply to the answer as provided for in Rule 37, respondent made no motion under Rule 37(c) that the factual allegations set forth in the answer be deemed admitted.

[7] Although the Court repeatedly directed him to summarize the (footnote continued)

> 1. "Copy of contract between IRS and U.S. Attorney's office."
>
> 2. "Copy of Enabling Act of the Internal Revenue Service."
>
> 3. "Copy of all Tax Returns and tax information on the Judge assigned to this case."
>
> 4. "Copy of reports of all visits to all Federal Judges by the Internal Revenue Service within the past 5 years."

It became apparent to the Court that petitioner had not informally sought information from respondent prior to resorting to formal discovery as prescribed by Rule 70(a), that there was no motion to compel discovery under Rule 104 pending before the Court, and that the bulk of information sought by the taxpayer was irrelevant in the context of the instant controversy. The Court therefore informed petitioner that it would not compel production of the documents sought by him. Petitioner thereafter refused to proceed with the merits of the case, despite the Court's urging him to do so. At that time, counsel for respondent moved to dismiss this case for failure of petitioner properly to prosecute. The Court informed the parties that it

---

(footnote continued from previous page)
substantive issues herein, petitioner refused to do so. Despite his having personally signed and filed a petition herein, petitioner insisted that it was the Internal Revenue Service, and not he, who had invoked the jurisdiction of this Court.

intended to grant respondent's motion and that the case would be called at 2:00 p.m. on the afternoon of March 4, 1986, for the purpose of submitting the case on the fraud issue. When the case was recalled for trial at such time, petitioner did not appear. The case then proceeded to trial on the fraud issue for 1980 and 1981.

OPINION

The first issue is whether respondent's motion to dismiss this case for failure of petitioner properly to prosecute should be granted. Rule 123(b) is relevant in this context, and provides as follows:

> Dismissal: For failure of a petitioner properly to prosecute or to comply with these Rules or any order of the Court or for other cause which the Court deems sufficient, the Court may dismiss a case at any time and enter a decision against the petitioner. The Court may, for similar reasons, decide against any party any issue as to which he has the burden of proof; and such decision shall be treated as a dismissal for purposes of paragraphs (c) and (d) of this Rule.

It is evident from petitioner's conduct at the call of this case that petitioner had no intention of proceeding in an orderly and proper manner before this Court. He insisted that this Court order discovery even though he had not followed the discovery procedures prescribed by this Court's Rules of Practice and Procedure and even though the bulk of documents sought by him were irrelevant with respect to his liability for the deficiencies and additions to tax determined by respondent herein. When the Court informed petitioner that it would not order the discovery sought by him, petitioner steadfastly refused to proceed with the merits of this case. We think that petitioner's conduct constitutes a failure to properly prosecute this case. Accordingly, respondent's motion to dismiss is granted. A decision against petitioner will therefore be entered with respect to the underlying deficiencies as set forth in the notice of deficiency, as to which petitioner bears the burden of proof. See Rules 123(b), 142(a).[8]

The second issue is whether petitioner is liable for an addition to tax for 1980 and 1981 under section 6653(b). That section provides that there shall be added to the tax an amount equal to 50 percent of the underpayment of tax if any part of the underpayment is due to fraud. Sec. 6653(b). Respondent bears the burden of proving by clear and convincing evidence that petitioner underpaid his tax, and that some portion of this underpayment was due to fraud. See sec. 7454(a); Rule 142(b); Hebrank v. Commissioner, 81 T.C. 640, 642 (1983)

---

[8] Under Rule 123(b), dismissal may be premised upon a petitioner's failure to comply with the rules of this Court. We note that, consistent with petitioner's failure to discuss the substance of his case at trial, paragraph 5 of the petition herein merely contains conclusory allegations concerning respondent's authority to act, and does not set forth justiciable facts concerning petitioner's Federal income tax liability as required by Rule 34(b)(5). See n. 5, supra. Accordingly, our dismissal of this case finds additional support in petitioner's failure to comply with Rule 34(b). In any event, under Rule 142(a), petitioner bears the burden of proving error with respect to the deficiencies determined by respondent, and his refusal to address the merits of this case or to introduce evidence at trial constitutes a failure by him to carry such burden.

Respondent has shown by affirmative evidence that petitioner earned wages from AMC in 1980 and 1981 in the respective amounts of $24,011.03 and $20,650.52, and that he failed to properly report his wages as income or to pay the taxes due on them. The existence of an underpayment is therefore established. See sec. 6653(c). We must therefore determine whether any portion of this underpayment was due to fraud. The existence of fraud is essentially a question of fact to be determined based upon a consideration of the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978); Stratton v. Commissioner, 54 T.C. 255, 284 (1970). For this purpose, fraud is an intentional wrongdoing on the part of the taxpayer motivated by the specific purpose of evading a tax known or believed to be owing. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3rd Cir. 1968). Fraud will never be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Because direct proof of fraudulent intent is seldom possible, fraud may be proved by circumstantial evidence emanating from the taxpayer's entire course of conduct. Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983); Grosshandler v. Commissioner, 75 T.C. 1, 19 (1980); Stone v. Commissioner, 56 T.C. 213, 223-224 (1971). Such evidence includes conduct intended to conceal, mislead or otherwise prevent the collection of tax. Rowlee v. Commissioner, supra at 1123; Gajewski v. Commissioner, supra at 200; Beaver v. Commissioner, supra at 92-93.

After considering the facts of the instant case, we are persuaded that respondent has satisfied his burden of proof. The record demonstrates that petitioner failed to file Federal income tax returns for 1980 and 1981. The failure to file an income tax return is not, standing alone, proof of fraud on the part of the taxpayer. *Kotmair v. Commissioner*, 86 T.C.___ (June 19, 1986). However, such failure is evidence which may be considered as indicative of fraud. *Rowlee v. Commissioner*, *supra*. Based upon the record as a whole, we think that petitioner's purpose in failing to file returns during such years was to evade the payment of Federal income taxes which he knew to be due and owing. The fact that petitioner had previously filed Federal income tax returns for the years 1974 through 1978, inclusive, is evidence that he knew of his obligation to pay Federal income tax with respect to his income. Additional evidence of petitioner's fraudulent intent is found in his filing of false withholding forms (Forms W-4) with AMC during 1980 and 1981. It is well established that the filing of false withholding forms is evidence of fraud. *Rowlee v. Commissioner*, *supra* at 1125; *Stephenson v. Commissioner*, 79 T.C. 995, 1007 (1982), affd. 748 F.2d 331 (6th Cir. 1984); *Habersham-Bey v. Commissioner*, 78 T.C. 304, 313-314 (1982). As a result of the false W-4 forms filed by petitioner, no Federal income tax was withheld by AMC from petitioner's wages during the period from February 1980 to July 1981. Petitioner's filing of false withholding forms thus disrupted the orderly process of tax collection. See *Hebrank v. Commissioner*, *supra* at 643. Even after AMC recommenced the withholding of Federal income tax from petitioner's wages at the direction of the Internal Revenue Service in July 1981, petitioner again tried to interfere with the collection of the tax by writing to AMC's legal department and instructing them to refrain from withholding.

We are convinced from the record that petitioner knowingly engaged in deliberate conduct intended to defeat the payment of Federal income tax which he knew to be owing. Accordingly, we hold that respondent has satisfied his burden of proving fraud by clear and convincing evidence. Petitioner is therefore liable for the addition to tax under section 6653(b) for 1980 and 1981.

To reflect respondent's concession as to the addition to tax for fraud for 1979 and the foregoing,

An appropriate order
and decision will be entered.

11 742-13 Ju 11.7/2: 1986-385

#214

IGINAL

T. C. Memo. 1986-385

UNITED STATES TAX COURT

HERBERT BYRD, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 12928-83. Filed August 19, 1986.

Donald F. Van Cook, for the petitioner.

David Goldberg, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JACOBS, Judge: Respondent determined a deficiency in petitioner's 1981 Federal income tax in the amount of $6,507 and an addition to tax under section 6653(a)[1] in the amount of $325.35. After concessions, the issues for decision are: (1) whether petitioner is entitled to a charitable contribution

---

[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue.

3L

deduction in the amount of $13,977; (2) whether petitioner is entitled to dependency exemptions for six of his children; (3) whether petitioner may calculate his tax liability by claiming "head of household" filing status; and (4) whether petitioner is liable for the additions to tax under section 6653(a).

Some of the facts have been stipulated; this reference incorporates herein the stipulation of facts and attached exhibits.

During the year in issue (1981), as well as the date on which the petition was filed, petitioner resided at 39 Brooklyn Avenue, Wyandanch, New York (the Brooklyn Avenue property). During 1981, he was employed, on a full time basis, by the Long Island Lighting Company ("LILCO") as a mechanic.

Issue 1. Charitable Contribution Deduction

FINDINGS OF FACT

On January 3, 1978, petitioner filed with the State of New York a Certificate of Incorporation (the Charter) for the Brooklyn Avenue Church of the Apostolic Faith (the Church) which stated as its purpose the preaching of religious doctrine. The Charter was amended on November 29, 1982, to include a dissolution clause, i.e., a statement that upon dissolution of the Church, its assets would be distributed "to such organization as shall qualify under Section 501(c)(3) of the Internal Revenue Code of 1954, as amended, or to another organization to be used in such manner as in the judgment of a justice of the Supreme Court of the State of New York will best accomplish the general purposes for which this corporation was formed." No dissolution clause appeared in the original Charter, nor was the amendment made retroactive to 1981.

The Church operated out of the Brooklyn Avenue property which petitioner individually owned. When petitioner purchased the Brooklyn Avenue property in 1976, he borrowed $32,250 from Allied Federal Savings & Loan Association of New York and executed a mortgage in that amount. The ground level of the Brooklyn Avenue property was subsequently dedicated for use by the Church -- the area contained folding chairs arranged in rows, a pulpit, an organ, and voice amplification devices. In addition, restrooms on that level were designed for public use, and a room was used as petitioner's study. The Church congregation averaged 20 adults at its regular Sunday services.

During 1981, petitioner wrote checks totalling $10,654 to the Church, from his personal checking account; he claims to have contributed another $3,338 to the Church in cash. These funds (totalling $13,992) represented the bulk of, if not the sole, support received by the Church during 1981.

The Church maintained a checking account (over which petitioner had sole signatory control) at Marine Midland Bank. During 1981, the Church paid the mortgage and property taxes on the Brooklyn Avenue property as well as all utility bills. The Church also repaid petitioner's personal loan to a finance company.

Petitioner used an automobile owned by the Church to commute to and from his job at LILCO; the Church paid for all the automobile expenses.

In his 1981 return, petitioner deducted $13,992[2] as a charitable contribution to the Church. Respondent disallowed this deduction claiming that: (1) the Church was neither organized nor operated exclusively for religious purposes; (2) Church funds were used for petitioner's benefit; and (3) petitioner did not relinquish dominion and control over the funds contributed to the Church.

OPINION

Section 170(a) allows as a deduction a contribution or gift made within the taxable year to those entities described in section 170(c). To qualify as an entity described in section 170(c), the Church must satisfy both an organizational and operational test. Stephenson v. Commissioner, 79 T.C. 995, 1002 (1982), affd. per curiam 748 F.2d 331 (6th Cir. 1984); Section

---

[2] Petitioner also deducted interest on the mortgage ($2,614) and real estate taxes on the Brooklyn Avenue property ($2,305), both paid by the Church. Thus, he twice deducted the mortgage interest and real estate taxes.

1.501(c)(3)-1(a)(1), Income Tax Regs. If the Church fails to satisfy either test, it does not qualify. Here, the Church satisfied neither test.

The Church failed to satisfy the organizational test because under its Charter, as in effect for 1981, its assets were not irrevocably dedicated to an exempt purpose. Sec. 1.501(c)(3)-1(b)(4), Income Tax Regs.[3] The Church also failed to satisfy the operational test because its earnings inured to the benefit of a private individual (i.e., petitioner).[4] Sec. 1.501(c)(3)-1(c)(2). Many of petitioner's personal expenses, including the expense of maintaining his home (e.g., mortgage, real estate taxes and utilities) were paid by the Church. Additionally, the Church-owned automobile was used by him to commute to and from his job at LILCO.

In addition to failing both the organizational and operational tests, petitioner did not part with dominion and control over the monies contributed to the Church; he was the sole signatory over the Church's checking account. This factor alone also would result in the denial of a deduction to petitioner for his contributions to the Church. See Stephenson v. Commissoner, supra.

---

[3] The organizational test was satisfied only after the Church's Charter was amended on November 29, 1982 to include a dissolution clause.

[4] Petitioner's argument that the Church had no earnings, hence none of its earnings could have been used for his benefit, is without merit. Any use of Church property, including its funds, for the benefit of a private individual is proscribed. See Canada v. Commissoner, 82 T.C. 973 (1984).

Although none of petitioner's contributions to the Church are deductible, he is permitted to deduct contributions made to other churches. These contributions were not specifically contested by respondent at trial or on brief. From an examination of a list of checks written on petitioner's personal checking account, we conclude that he made, and is entitled to deduct, $320 in contributions to other churches, of which only $15 was allowed by respondent.

Issue 2. Dependency Exemption

FINDINGS OF FACT

In his 1981 return, petitioner claimed dependency exemptions for five children[5] from his former marriage to Ira Marie Byrd ("Ira"). That marriage was dissolved by a divorce decree entered October 8, 1975; Ira was granted sole custody of all the children. Petitioner also claimed a dependency exemption for Nicole, his child with Virginia Ann Hoyle.

---

[5] Janet, born May 17, 1961;
Sheila, born Oct. 2, 1965;
Rosetta, born Jan. 23, 1968;
Patrice, born June 1, 1970;
Brenda, born May 13, 1972.

Three of petitioner's and Ira's children (Janet, Sheila and Rosetta) lived in part during 1981 with petitioner and in part with Ira. Their two youngest children (Patrice and Brenda) lived during all of 1981 with Ira. Nicole was in college in 1981 and lived in part with petitioner.

During 1981, Ira received $8,025 in the form of aid to Dependent Children (ADC) from the Suffolk County (N.Y.) Department of Social Services for support of her and petitioners' children. In addition, she received $1,820 from petitioner[6] as child support. Petitioner paid Nicole's college expenses and supported her.

In support of his claim that he is entitled to six dependency exemptions, petitioner asserts that (1) three of his and Ira's five children (Janet, Sheila and Rosetta) lived with him for more than half of 1981; (2) the other two of his and Ira's five children were provided with court-ordered support payments for which he should be given credit; and (3) Nicole was in college and he supported her.

Respondent disallowed all six of the claimed dependency exemptions on the basis that petitioner failed to prove that he provided over half of their support.

---

[6] The $1,820 was subtracted from petitioner's salary, at the rate of $35 a week, and remitted by LILCO to Ira.

OPINION

A parent is allowed a dependency exemption for each child for whom the parent provides over half the yearly support. Sections 151(e) and 152. In determining whether the parent provided over half the yearly support, the amount of support received from the parent must be compared to the entire amount of support provided the child from all sources. Sec. 1.152-1(a)(2)(i), Income Tax Regs. ADC payments made by a State agency on behalf of a child constitute support by the agency, and not by the parents. Lutter v. Commissioner, 61 T.C. 685 (1974), affd. per curiam 514 F.2d 1095 (7th Cir. 1975), cert. denied 423 U.S. 931 (1975).

In 1981, Ira received $8,025 in ADC payments and $1,820 from petitioner as child support. Ira did not testify; thus, we do not know how much she contributed to the support of her and petitioner's five children. On the record before us, we find that Ira and petitioner together did not contribute over half the support of any of their children; therefore, petitioner is not entitled to a dependency exemption for any of his children with Ira.[7]

Petitioner testified that Nicole lived with him in 1981, leaving home only for the purpose of attending college in North Carolina. He further testified that he supported her.

---

[7] Since we have concluded that Ira and petitioner combined did not contribute over half the support for any of their children, we need not determine which of them is entitled to the dependency exemption. See section 152(e).

Respondent did not provide any evidence to contradict such testimony. Therefore, based on the record, we find that petitioner provided Nicole with over half of her support for 1981 and thus he is entitled to a dependency exemption for her.

Issue 3. Head of Household Filing Status

FINDINGS OF FACT

Petitioner filed his 1981 return on the basis of "head of household" filing status. Respondent claims that petitioner is not entitled to file using "head of household" status.

OPINION

A "head of household" is an individual who is not married at the close of the taxable year and who maintains as his home a household which constitutes for such taxable year the principal place of abode of an unmarried child. Section 2(b). A taxpayer is considered as maintaining a household only if over half of the cost of maintaining the household during the taxable year is furnished by him. The taxpayer and the unmarried child must occupy the household for the entire taxable year, except for temporary absences due to special circumstances. The regulations include in the category of "special circumstances" a nonpermanent absence from the abode due to education, or due to a custody agreement "under which a child * * * is absent for less than 6 months in the taxable year of the taxpayer," if "(i) it is reasonable to assume that the taxpayer or such other person will return to the household, * * *" Sec. 1.2-2(c)(1), Income Tax Regs.

Our finding that petitioner supported Nicole during 1981 and that she lived with him except while attending college facilitates a finding that petitioner may file his 1981 return on the basis of "head of household." Nicole's attendance at college constituted a temporary absence from petitioner's household due to a special circumstance. Section 1.2-2(c)(1), Income Tax Regs.

Issue 4. Negligence Penalty

FINDINGS OF FACT

Respondent asserts that petitioner's underpayment of tax was due to negligence or intentional disregard of the rules and regulations and seeks additions to tax under section 6653(a)(1) and 6653(a)(2). Petitioner disagrees.

OPINION

The burden is on petitioner to prove that no part of his underpayment was due to negligence or intentional disregard of the rules or regulations within the meaning of section 6653(a). Bixby v. Commissioner, 58 T.C. 757, 791 (1972). Negligence is the lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967).

Upon a careful review of the record, we conclude that the imposition of the negligence penalty is warranted and we therefore sustain respondent's determination on this issue.

To reflect the foregoing,

Decision will be
entered under Rule 155.

COMPLETED 11-12-86
10

Ju 11.7/2: 1986-386

MF 214

ORIGINAL

T. C. Memo. 1986-386

UNITED STATES TAX COURT

REGIN ELLIS, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 34504-84, 3805-85. Filed August 19, 1986.

Peter R. Stromer, for the petitioner.

Donald Schwartz and Rhonda Barry, (specially recognized), for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KÖRNER, Judge: In these consolidated cases, respondent determined deficiencies of income tax and additions to tax against petitioner as follows:

		Additions to Tax[1]				
Year	Deficiency	§6651(a)(1)	§6653(a)(1)	§6653(a)(2)	§6653(b)	§6654(a)
1980	$ 5,631.03	-0-	-0-	-0-	$2,815.52	$ 377.59
1981	6,831.00	-0-	-0-	-0-	3,415.50	422.15
1982	8,162.00	$ 463.73	$ 408.10	[2]	-0-	27.05

By amendment to his answer in docket No. 34504-84 (for the years 1980 and 1981), respondent pleaded in the alternative, that in the event that additions to tax for fraud were disapproved for 1980 and 1981, there should be additions to tax for those years as follow:

Year	§6651(a)(1)	§6653(a)(1)	§6653(a)(2)
1980	$1,383.51	$ 281.55	-0-
1981	1,521.50	341.55	50% of interest on $6,086

In his answer filed herein in docket No. 3805-85 (for the year 1982), respondent affirmatively pleaded for additions to tax for fraud for the year 1982, and asked for additions to tax under section 6653(b)(1) of $4,081, and of 50 percent of the interest due on $8,162, under section 6653(b)(2).

---

[1] All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

[2] Fifty percent of the interest due on $8,162.

At the time of trial herein, petitioner conceded in full the correctness of respondent's original determinations with regard to the years 1980 and 1981, except for the fraud addition. Without conceding the correctness of respondent's determinations for the year 1982, petitioner's counsel announced that no evidence with respect to such determinations would be presented except as to the fraud issue, thus, in effect, defaulting with respect to such other issues. The addition under section 6653(b) remains the principal issue to be resolved in this case.3/

3/ Respondent, of course, has the burden of proof with respect to the fraud issue for all years. Sec. 7454(a); Rule 142(b). With respect to proposed additions to tax for the years 1980 and 1981 under sections 6651 and 6653(a), respondent also has the burden of proof with respect to such proposed additions, since they were pleaded in the alternative by respondent in his amended answer herein. Rule 142(a). With respect to the proposed additions under sections 6651(a) and 6653(a) for the year 1982, such proposed additions were contained in respondent's original notice of deficiency, and normally petitioner would have had the burden of proof with respect to them. Rule 142(a). In his answer filed herein with respect to the year 1982, however, respondent affirmatively pleaded for additions to tax for fraud under section 6653(b). Such pleading, which was not in the alternative, effectively eliminates respondent's determinations of additions to tax for the years 1982 under sections 6651(a)(1), 6653(a)(1) and 6653(a)(2). See sections 6653(b)(3) and 6653(d).

Respondent's determination of additions to tax under section 6654(a), in accordance with the original notice of deficiency, remain undisturbed by respondent's pleadings, and the burden of proof with respect thereto remained upon petitioner. Rule 142(a).

FINDINGS OF FACT

Some of the facts herein were stipulated by the parties (as corrected and amplified at trial), and such stipulations of fact, together with attached exhibits, are incorporated herein by this reference.

At the time his petition herein was filed, petitioner was a resident of Jamaica, New York. Petitioner filed no income tax returns for the years 1980 and 1981. For the year 1982, petitioner, on or about May 19, 1983, filed a Form 1040 with respondent. Such form, after disclosing petitioner's name and social security number, and an address given as "c/o Finance Director, Order of St. Matthew, 2090 Merrick Avenue, Merrick, New York 11566," disclosed that petitioner was filing as a single person, disclosed wages of $33,472.51 and then excluded the same amount from income as "wages nontaxable by reason of taxpayer being agent of Religious Order." The form thus disclosed adjusted gross income of zero. The form gave no other or further information with regard to petitioner's income, deductions or personal exemptions, but showed the entire amount of income tax and social security tax withheld, in the total amount of $8,477.89, as an overpayment of tax, and requested that the entire amount be refunded.

For the years 1980, 1981 and 1982, as well as well as for a number of years prior thereto, petitioner was employed in the capacity of train operator by the New York City Transit

Authority. There was no contract or other agreement between the New York City Transit Authority and any church or religious organization regarding petitioner's services. The New York City Transit Authority did not negotiate with any church or religious organization regarding petitioner's services. Petitioner's duties with the New York City Transit Authority during the years in question did not involve any religious duties. Petitioner's duties with the New York City Transit Authority were the same throughout the entire period in issue. Petitioner performed his services for the New York City Transit Authority during the period in question in his individual capacity. The wages paid to petitioner by the New York City Transit Authority for his services were paid directly to him, with no restrictions by the transit authority with respect to the use of such wages.

For the year 1982, petitioner received gross wages from the New York City Transit Authority in the amount of $33,472.51.

Under date of August 30, 1979, petitioner filed an "Employee's Withholding Allowance Certificate" (Form W-4) with his employer, the New York City Transit Authority. The certificate stated on its face: "This certificate is for income tax withholding purposes only; it will remain in effect until you change it." In this form, petitioner claimed 50 "allowances," or personal exemptions, at the rate of $1,000 each. The purpose of filing the form with the New York City Transit Authority was to induce petitioner's employer to compute petitioner's income tax withholding on his wages pursuant to an allowance of 50 personal exemptions. Such form remained in effect with petitioner's employer at least until May 1982, when the Internal Revenue Service notified the New York City Transit Authority to ignore this withholding certificate and withhold tax from petitioner's wages on the basis of one personal exemption. In 1983 and 1984, petitioner filed new and different Forms W-4 with the New York City Transit Authority, in which petitioner claimed to be "exempt" from the requirement of withholding tax on his wages.

For years 1980 and 1981, petitioner, apparently in response to an inquiry by the Internal Revenue Service, indicated by letter that his total income for the years in question was less than the amount required for filing an income tax return.

There was an underpayment of tax for each of the years 1980, 1981 and 1982, all of which was due to fraud by petitioner.

OPINION

For all the years here in issue, section 6653(b) provided, in relevant part: "If any part of any underpayment * * * of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment."

In addition, with respect to petitioner's calendar year 1982, a new section 6653(b)(2) provides as follows:

> (2) Additional Amount For Portion Attributable To Fraud.--There shall be added to the tax (in addition to the amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601--
>
> > (A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to fraud, and
> >
> > (B) for the period beginning on the last day prescribed by law for payment of such underpayment * * * and ending on the date of the assessment of the tax * * *.

For purposes of section 6653(b), fraud is the intentional commission of an act or acts with the specific purpose of evading a tax believed to be owing. See Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; McGee v. Commissioner, 61 T.C. 249 (1973), affd. 519 F.2d 1121 (5th Cir. 1975); Strachan v. Commissioner, 48 T.C. 335 (1967). The existence of fraud is a question of fact to be determined from the entire record. Grosshandler v. Commissioner, 75 T.C. 1 (1980); Stratton v. Commissioner, 54 T.C. 255 (1970). The burden of proof rests on respondent, and he must meet that burden with clear and convincing evidence. Sec. 7454(a); Rule 142(b); See Cefalu v. Commissioner, 276 F.2d 122 (5th Cir. 1960), affg. a Memorandum Opinion of this Court; Imburgia v. Commissioner, 22 T.C. 1002 (1954). Fraud is never presumed, but rather must be established by affirmative evidence. Beaver v. Commissioner, 55 T.C. 85 (1970). Circumstantial evidence is permitted where direct evidence of fraud is not available. Spies v. United

States, 317 U.S. 492 (1943); Rowlee v. Commissioner, 80 T.C. 1111 (1983); Gajewski v. Commissioner, 67 T.C. 181 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). The mere failure to file a return, without more, is not proof of fraud but may be considered in connection with other facts. Kotmair v. Commissioner, 86 T.C. ___ (June 19, 1986); Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968). Fraud may be properly inferred where an entire course of conduct establishes the necessary intent. Rowlee v. Commissioner, supra; Stone v. Commissioner, 56 T.C. 213 (1971). In addition to the necessary fraudulent intent, respondent must show that there was an underpayment of tax in each year. Shaw v. Commissioner, 27 T.C. 561 (1956), affd. 252 F.2d 681 (6th Cir. 1958); Stone v. Commissioner, supra.

Applying the above principles to the facts of the instant case, we conclude that respondent has carried his necessary burden of proof to establish petitioner's liability for fraud in each of the years before us.

The fact of underpayments of tax in each of the years 1980 and 1981 is established by petitioner's concession, in open court, of the deficiencies of tax for those years. The fact of an underpayment of tax for the year 1982, although not expressly conceded by petitioner, is established by petitioner's receipt of the wages which we have found, his failure to report any tax with respect thereto, and his failure to offer any evidence which would lead to a contrary conclusion.

The fact of petitioner's fraudulent intent is satisfactorily established by petitioner's filing of a false and misleading Form W-4, which, as we have found, claimed 50 exemptions and was in effect for all the years before us. We find petitioner's claim of 50 withholding allowances or exemptions to be inherently incredible, particularly in the absence of any evidence which would support such an outrageous claim. The filing of a false withholding certificate will support a finding of fraud. See Stephenson v. Commissioner, 79 T.C. 995 (1982), affd. 748 F.2d 331 (6th Cir. 1984); Scholle v. Commissioner, T.C. Memo. 1982-267.

No evidence at all was presented at trial to substantiate the claim made by petitioner in the Form 1040 filed for 1982 that petitioner was a member of some religious order and thus was not taxable upon his wage income. Indeed, although respondent sought petitioner's attendance at trial by subpoena, petitioner apparently evaded the service of process and failed to appear; his counsel disclaimed all knowledge of his whereabouts. There is simply nothing in this record to demonstrate that petitioner had any legitimate and bona fide belief that he was not taxable on his wages, paid directly to him without restriction as a train operator for the New York City Transit Authority, or that he thought it was proper for him to defeat the withholding of income tax from his wage income by filing a preposterous W-4 Form claiming 50 personal exemptions.

We accordingly sustain respondent's position that additions to tax for fraud, in accordance with respondent's statutory notice in docket No. 34504-84, and in accordance with respondent's answer in docket No. 3805-85, should be sustained.

As to the remaining proposed addition to tax under section 6654(a), petitioner conceded such additions as to the years 1980 and 1981 at the time of trial herein. As to such addition for the year 1982, as contained in respondent's statutory notice, the burden of proof with respect to such addition was upon petitioner, Grosshandler v. Commissioner, 75 T.C. 1 (1980); he failed to introduce to any evidence with respect thereto, and respondent's additions under section 6654 for all three years is accordingly approved.

To give effect to the elimination of the proposed additions to tax under sections 6651 and 6653,

Decisions will be entered
under Rule 155.

13 7-12-B

Ju 11.7/2:1986-387

mf 214

ORIGINAL

T. C. Memo. 1986-387

UNITED STATES TAX COURT

1969 CORP., ET AL.,[1] Petitioners v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket Nos. 22210-82, 22354-82, 22355-82. Filed August 19, 1986.

William L. Raby and John C. Fossum, for the petitioners.

Terence D. Woolston, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, *Judge*: In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes as follows:

---

[1] The following cases are consolidated herewith for trial, briefing, and opinion: Nancy R. Pitt, docket No. 22354-82 and Donald Pitt and Nancy R. Pitt, docket No. 22355-82.

Petitioner	Docket No.	Year	Deficiency
1969 Corp.	22210-82	03/31/73	$ 99
		03/31/74	1,530
		03/31/75	1,439
		03/31/76	1,120
		03/31/77	3,921
		03/31/78	946
Nancy R. Pitt	22354-82	12/31/76	1,940
		12/31/77	3,683
		12/31/78	5,248
		12/31/79	10,682
Donald and Nancy R. Pitt	22355-82	12/31/74	1,359
		12/31/75	7,296

By amended answers, respondent increased the deficiency in Docket No. 22210-82 to $7,120 for fiscal year 1976 and increased the deficiency in Docket No. 22355-82 to $79,271 for calendar year 1975.

After concessions, including stipulations to be bound in certain respects by decisions in related cases,[2] two issues remain for decision in these cases: (1) How and when should petitioners' partnership report certain cash and promissory notes received from third parties in exchange for the release of the third parties from liability under a lease; and (2) when may the partnership deduct the unamortized balance of certain leasehold acquisition costs?

---

[2] The parties have stipulated to be bound on certain issues by our decision in Moss v. Commissioner, T.C. Memo. 1986-128. Accordingly, appropriate adjustments will be made under Rule 155 in Docket No. 22354-82 and Docket No. 22210-82.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts, supplemental stipulation of facts, and exhibits attached thereto are incorporated herein by reference.

Petitioner in Docket No. 22210-82, 1969 Corp., had its principal office and place of business at all relevant times in Tucson, Arizona, and filed income tax returns for its fiscal years 1973 through 1978, with the Internal Revenue Service Center, Ogden, Utah. All of the outstanding stock in 1969 Corp. was at all relevant times owned 50 percent by Richard L. Bloch and 50 percent by petitioner Donald Pitt, alone or in conjunction with petitioner, Nancy R. Pitt.

Petitioners in Docket No. 22355-82, Donald and Nancy R. Pitt, resided in Tucson at the time their petition was filed. They filed joint income tax returns for the years 1974 and 1975 with the Ogden Service Center.

Petitioner in Docket No. 22354-82, Nancy R. Pitt, resided in Tucson when her petition was filed and filed returns as an unmarried head-of-household for the years 1976, 1977, 1978, and 1979 with the Ogden Service Center.

In these cases all of the adjustments made by respondent to petitioners' returns arose out of transactions of ARIZ, a California limited partnership organized in 1969, in which all petitioners were partners at one time or another. Under ARIZ's original partnership agreement, 1969 Corp. was its general partner with a 5 percent interest in the partnership profits and losses while Richard L. Bloch and Donald Pitt were its limited partners with each having a 47.5 percent interest in the partnership profits and losses. The ownership of the partnership interests continued in this manner until at or about the end of 1975 when Nancy R. Pitt acquired a 4.75 percent interest from Donald Pitt. During 1976 through 1979 the partnership interests were owned as follows:

1969 Corp.	5.00 percent
Donald Pitt	42.75 percent
Nancy R. Pitt	4.75 percent
Richard L. Bloch	47.50 percent

On December 31, 1969, ARIZ acquired a dual leasehold interest in the Los Angeles International Airport Hotel (LAX Hotel). Insofar as relevant here the dual leasehold interest had been created and passed along to ARIZ by the series of transactions set out below:

(1) On July 28, 1962, International Airport Hotel Systems (IAHS), the owner of certain land located near the Los Angeles International Airport, as lessor, entered into a lease agreement with its wholly-owned subsidiary, Airportel, Inc., as lessee. Under the lease agreement IAHS agreed to construct upon the land a first class hotel and to lease the same to Airportel. On its part Airportel agreed to maintain and operate the hotel and pay certain specified rents. The initial term of the lease was to be for a period of 25 years, commencing on September 1, 1962 and ending on August 31, 1987, with Airportel having three options to renew of 25, 25, and 24 years;

(2) On August 30, 1962, IAHS conveyed the LAX Hotel property to the Kratter Corporation. The conveyance was made subject to the lease in favor of Airportel and was accompanied by an agreement under which IAHS assigned all of its right, title and interest under the lease with Airportel to Kratter Corporation and guaranteed the performance by Airportel of all of Airportel's obligations as lessee under the lease;

(3) Subsequently, Kratter Corporation conveyed the LAX Hotel property to Towcrat Corporation and assigned all of its right, title and interest in and to the lease with Airportel to Towcrat;

(4) On August 22, 1967, Towcrat as the owner and landlord of LAX Hotel entered into an Indenture of Lease with Countrywide Realty (Countrywide) as tenant which incorporated with certain modifications the original lease between IAHS and Airportel, including the initial term to August 31, 1987 and the three renewal options. One of the modifications was to the effect that at any time after September 1, 1977 Countrywide could terminate the lease with Towcrat, but in such event the termination by Countrywide would constitute an assignment by Countrywide to Towcrat of all of Countrywide's interest in and to the lease with Airportel. The net effect of the Indenture of Lease between Towcrat and Countrywide was to "sandwich" Countrywide into the original lease between Towcrat and Airportel. As a result, Countrywide acquired dual leasehold interests in the property, i.e., first as the lessee of Towcrat and secondly as the lessor of Airportel;

(5) On or about August 23, 1967, Towcrat conveyed the LAX Hotel and Towcrat's lessor position under the sandwich lease with Countrywide to four individuals who subsequently were succeeded by a partnership known as Almo Enterprises which still later was succeeded by Almo Hotel Company, another partnership;[3]

(6) On March 31, 1969, Great Plains Hotel Company succeeded to Countrywide's interests in the LAX Hotel property; and

(7) On December 31, 1969, Great Plains conveyed various property interests, including the dual position it had acquired in the LAX Hotel property from Countrywide in (6) above, to ARIZ for a total stated consideration of $4,535,631.63. Thereafter ARIZ was the lessee under a lease with Almo as lessor and at the same time was lessor under the lease with Airportel.

In the agreement between Great Plains and ARIZ, the parties agreed that the sum of $852,656.00[4] would be allocated to the balance of the initial term of the sandwich lease and that the sum of $1,196,024.33 would be allocated to the three renewal terms of that lease.[5]

---

[3] For easy reference, both Almo Enterprises and Almo Hotel Company will hereinafter be referred to as Almo inasmuch as their interests appear to be identical.

[4] This figure represents the excess of the rent to be received by ARIZ from Airportel through August 31, 1987 over the amount of rent ARIZ was obligated to pay out under the sandwich lease. It also represents approximately 42 percent of the total leasehold acquisition costs of $2,048,680.

[5] The sandwich lease of August 22, 1967 between Towcrat (lessor) and Countrywide (lessee) incorporated the terms of the original operating lease which provided for an initial lease term ending August 31, 1987 and three renewal periods ending in 2061.

In accordance with the agreement between ARIZ and Great Plains $852,656 was allocated by ARIZ to the acquisition costs of the remainder of the initial term of the sandwich lease and $1,196,024.63 was allocated as the acquisition costs of the three renewal terms. During 1970 through 1974 ARIZ amortized $278,040 of the $852,656 allocated to the initial term, leaving an unamortized balance of the acquisition costs of the original term at the end of 1974 of $574,616. No part of the $1,196,024.33 allocated to the renewal terms was amortized during this period.

From 1970 through 1974 Airportel suffered increasing financial problems with the result that by 1974 the rents due ARIZ were in arrears and the LAX Hotel property was deteriorating. During the latter part of 1974 and the early part of 1975 ARIZ began to negotiate with Airportel and IAHS, its parent, and its guarantor under the original lease, in an attempt to rectify the situation. These negotiations ultimately led to a Settlement Agreement which was executed on August 12, 1975 by ARIZ, Airportel, IAHS, Almo, and others.

Under the settlement agreement Airportel's operating lease on the LAX Hotel property was terminated and IAHS was released from any and all obligations under the lease and its guarantee of Airportel's performance. In consideration for the termination of the lease and the release of IAHS from its guarantee ARIZ received (1) $450,000, (2) three interest-bearing promissory notes in the total principal amount of $1,500,000 which were executed by IAHS and secured by a mortgage on certain hotel property owned by IAHS and located in Florida, and (3) all of the stock outstanding in Airportel. The Airportel stock apparently had no value because the parties had agreed that any net assets of Airportel as of August 1, 1975 were to be remitted to IAHS. The promissory notes had an agreed fair market value in 1975 of $250,000. They were paid in full during the years 1976, 1977, 1978 and 1979.

On August 13, 1975, a new lease on LAX Hotel was entered into by ARIZ and Airportel. The base term of the new lease was from August 13 to December 31, 1975. Under the new lease Airportel had two renewal options for ten years each.

On its partnership return for 1975 ARIZ reported as rental receipts the cash of $450,000 and the fair market value ($250,000) of the three notes received from IAHS. On the same return ARIZ expensed the balance ($574,616) of the unamortized acquisition costs allocated to the initial term of the sandwich lease. On its partnership returns for 1976 through 1979 ARIZ reported the principal payments received on the IAHS notes as long term capital gains.

In his statutory notices, respondent determined that the payments received by ARIZ from IAHS in 1975 ($450,000), 1976 ($320,000), 1977 ($240,000), 1978 ($276,000), and 1979 ($664,000) constituted amounts received for cancellation of a lease and were reportable by ARIZ as ordinary income in the years received. Respondent also determined that the unamortized balance of the acquisition costs originally allocated to the initial term of the sandwich lease ($574,616) were recoverable by ARIZ through equal annual amortization allowances over the remaining life of the lease.

OPINION

From our detailed findings of fact it is apparent that ARIZ and Great Plains clearly, precisely, and dealing at arm's-length agreed in 1969 that the total acquisition costs of the sandwich lease was $2,048,680. The same parties, at the same time, and under the same circumstances agreed that $852,656.00 of the total acquisition costs was allocable to the initial term of the lease and that the balance of $1,196,024.33 was allocable to the three renewal terms. Over the next five years ARIZ expensed and respondent did not question annual amortization allowances with respect to the initial term of the lease totaling $278,040.00. Consequently, in August of 1975, the unamortized acquisition costs allocated to the initial term of the lease was $574,616.00. Since no amortization had been claimed by ARIZ with respect to the acquisition costs allocated to the renewal terms, the total amount of $1,770,640 was still unamortized in 1975.

From our findings of fact it is equally apparent that in August of 1975 Airportel and IAHS gave ARIZ $450,000 and three promissory notes having a face value of $1,500,000 and a current fair market value of $250,000 in exchange for a complete cancellation of the lease with Airportel, the release of

Airportel from the rents and other amounts such as the cost of repairs due under the lease, and the release of IAHS from the guarantee of Airportel's performance under the lease.

We must decide how to treat both the consideration received by ARIZ for canceling the operating lease and ARIZ's leasehold acquisition costs.

Cash and Promissory Notes

The consideration received by ARIZ in the 1975 transaction for canceling the lease[6] was a substitute for rental payments and, as such, constituted ordinary income. Section 1.61-8(b), Income Tax Regs.; Hort v. Commissioner, 313 U.S. 28, 31 (1941). The $450,000 of cash was reportable by ARIZ as ordinary income in the year of receipt. Section 1.61-8(b), Income Tax Regs. ARIZ also was required to report ordinary income of $250,000 upon receipt of the notes because the notes had an agreed ascertainable fair market value of $250,000. Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975). Furthermore, the 1975 transaction was closed when ARIZ received the notes and cash, and ARIZ acquired a basis of $250,000 in the notes at that time. Tombari v. Commissioner, 299 F.2d 889, 893 (9th Cir. 1962).

The subsequent payments on the notes were separate and distinct transactions required to "stand on [their] own feet." Tombari v. Commissioner, supra at 893. ARIZ eventually collected the full amount of the notes, realizing a gain of $1,250,000.

---

[6] In spite of petitioners' contention to the contrary, we find no reason to separately allocate any part of the cash or notes to the release of the guarantee. Once the operating lease was canceled, IAHS no longer had any obligations, and the guarantee was meaningless.

Since in 1975 there was considerable doubt whether the notes would be paid in full, as is evidenced by their low fair market value, ARIZ was entitled to fully recover its basis in the notes before reporting any gain. Liftin v. Commissioner, 36 T.C. 909, 911 (1961). Consequently, the first $250,000 received by ARIZ was a recovery of basis and not reportable as income, but all subsequent receipts were reportable.

Respondent contends that ARIZ's gain on the notes was ordinary income, whereas petitioner claims that the gain was capital gain. ARIZ's gain was capital gain if the retirement of the notes constituted the sale or exchange of a capital asset. Section 1222. Under section 1232,[7] the payments on the notes were amounts received in exchange for the notes[8]; therefore, the only issue is whether the notes were capital assets in ARIZ's hands.

Section 1221 defines the term "capital asset" as any property held by the taxpayer except certain types of property expressly listed in the statute. We find that the notes fall within this statutory definition since they do not come within any of the listed exclusions. We also find that the notes do not come within any of the judicial exceptions to the statutory definition found in the cases cited by respondent, including Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955). However, all of these cases are clearly distinguishable from our case on their facts. We conclude, therefore, that the notes were capital assets and that ARIZ's gain was capital gain.

---

[7] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

[8] Relying on Estate of Stahl v. Commissioner, 52 T.C. 591 (1969), affd. in part 442 F.2d 324 (7th Cir. 1971), respondent contends that section 1232 does not apply to these notes because they were merely evidence of IAHS's obligation to pay. However, characterizing the notes in such manner is inconsistent with respondent's position, as stated in its answer, that the notes were includable in income when received. See Williams v. Commissioner, 28 T.C. 1000, 1001 (1957).

Leasehold Acquisition Costs

ARIZ's initial cost basis in the sandwich lease was $2,048,680, and $1,770,640 of this amount was unamortized at the end of 1974. Under section 1.162-11(a), Income Tax Regs., these unamortized costs are to be deducted over the unexpired term of the lease.

Section 178 contains the statutory test for determining the proper amortization term. That section generally provides that if less than 75 percent of the cost of acquiring the lease is attributable to the initial term, the amortization term includes any renewal periods, unless the lessee establishes that it is more probable that the lease will not be renewed. In this case, approximately 42 percent ($852,656) of the total acquisition costs ($2,048,680) was allocated to the initial term of the sandwich lease. The balance or 58 percent was allocated to the renewal periods. Consequently, under section 178 the amortization term include the renewal periods unless petitioners have established an unlikelihood of renewal.

We find nothing in the record to support petitioner's claim that in 1975 it was more likely than not that the sandwich lease would be terminated by ARIZ on September 1, 1977.[9] To the contrary, there is no evidence that ARIZ attempted to terminate the lease in 1977, and as of the date of trial, apparently Almo and ARIZ were both still working hard to maintain their lessor-lessee relationship. Therefore, the balance of $1,770,640 in leasehold acquisition costs should be amortized over the balance of the initial term plus the renewal periods, i.e., from 1975 through 2061.

To reflect the foregoing, as well as the stipulations and concessions of the parties,

Decisions will be entered
under Rule 155.

---

[9] One of the modifications in the original sandwich lease between Towcrat and Countrywide of August 22, 1967 gave Countrywide (ARIZ's predecessor) the right to terminate the sandwich lease after September 1, 1977.

742-B Ju 11.7/2:1986-388

COMPLETED

12

x 214

T. C. Memo. 1986-388 ORIGINAL

UNITED STATES TAX COURT

LINCOLN L. and FRANCES N. LIBBY, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 33520-83. Filed August 20, 1986.

Peter Stromer, for the petitioners.

M. Kendall Williams, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, Judge: Respondent determined deficiencies in petitioners' Federal income tax and additions to tax as follows:

Year	Deficiency	Additions to Tax Sec. 6653(a)[1]	Sec. 6653(a)(2)[2]
1979[3]	$1,005.00	$53.00	--
1980	1,593.00	80.00	--
1981	1,260.00	63.00	50% of the interest due on $1,260.00

---

[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Section 6653(a)(2), is effective for taxes the last date prescribed for payment of which is after December 31, 1981. This section provides:

> There shall be added to the tax (in addition to the amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601--
>
> (A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to the negligence or intentional disregard referred to in paragraph (1), and
>
> (B) for the period beginning on the last date prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax (or, if earlier, the date of the payment of the tax).

Because neither assessment nor payment of the tax has occurred in this case, the period described in section 6653(a)(2)(B) has not yet closed, and therefore, the amount of the addition to tax under section 6653(a)(2) for 1981 cannot be determined at this time.

[3] Petitioners and respondent timely entered into a consent to extend the time to assess the tax for taxable year ending December 31, 1979 to December 31, 1983. Accordingly, the assessment of tax for taxable year 1979 is not barred by the statute of limitations.

The issues to be decided are (1) whether petitioners are entitled to a charitable contribution deduction under section 170 for taxable years 1979, 1980, and 1981; (2) whether petitioners are liable for additions to tax under section 6653(a); and (3) whether petitioners are liable for damages under section 6673.

FINDINGS OF FACT

Some of the facts are stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

At the time they filed the petition in this case, petitioners Lincoln L. Libby and Frances N. Libby, husband and wife, maintained a mailing address at P.O. Box 1152, Carmel Valley, California. Petitioners timely filed joint Federal income tax returns for each of the years in question with the Internal Revenue Service Center at Fresno, California.

During the taxable years in issue, petitioner Lincoln L. Libby was employed by Monterey Tire Service, Seaside, California, as a manager and received wages from Monterey Tire Service. Petitioner Frances N. Libby was employed during taxable year 1979 as a housekeeping supervisor at Rippling River Center, a United States Department of Housing and Urban Development (HUD) facility for handicapped and disabled individuals.[4] During taxable year 1980, Mrs. Libby received wages from Eleanor Atkinson. Mrs. Libby received self-employment income during taxable year 1981, as well as wages from Sarah Oppenheimer and a distribution from a pension and profit-sharing plan.

Sometime prior to 1979, petitioners received a charter from the Universal Life Church, Modesto, California (ULC-Modesto), and established the Universal Life Church in the Wildwood, Carmel Valley, California (ULC-Wildwood). ULC-Wildwood has not been granted tax-exempt status under section 501(c)(3).[5]

On their 1979 return, petitioners reported cash contributions to unnamed organizations in the amount of $3,411. Similarly, petitioners reported cash contributions to unnamed organizations in the amount of $5,056 and other than cash contributions in the amount of $150 for a total of $5,206 on their 1980 return, and cash contributions in the amount of $3,207 and other than cash contributions in the amount of $105 for a total of $3,312 on their 1981 return.[6] In support of the charitable contributions taken as deductions on their 1981 return, petitioners submitted a copy of their canceled check in the amount of $100 made payable to "Universal Life Church in the Wildwood."

---

[4] At that time, Rippling River Center (the Center) was managed by Eskaton. Beginning in January 1980, the Monterey Housing Authority (Housing Authority) assumed management responsibilities for the Center. All Eskaton employees, including Mrs. Libby, were dismissed. The United States Department of Housing and Urban Development (HUD) subsequently sold the facility to the Housing Authority in July 1980.

[5] At the time the alleged contributions to the Universal Life Church were made, the Universal Life Church, Inc., Modesto, California (ULC-Modesto), was exempt from taxation under section 501(c)(3) of the Internal Revenue Code. The Internal Revenue Service subsequently revoked its determination that ULC-Modesto is a tax-exempt organization. Announcement 84-90, 1984-36 I.R.B. 32 (September 4, 1984).

In his notice of deficiency, respondent denied the claimed charitable contributions for lack of substantiation and for failure to meet the requirements of section 170 of the Internal Revenue Code.

OPINION

(1) Deductibility of Contributions

Under section 170,[7] a taxpayer is entitled to deduct contributions made to charitable organizations subject to certain limitations. In order to qualify for a deduction under section 170(c), petitioners must show (1) that the contributions were actually made; (2) that the contributions were made to a qualified tax-exempt organization; and (3) that no part of the net earnings of that organization inured to the benefit of any individual. *Davis v. Commissioner*, 81 T.C. 806 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985); *Miedaner*

---

[6] Petitioners attached a copy of their California State income tax return to their Federal income tax return for each of the years in issue. Mr. and Mrs. Libby's 1979 State income tax return shows cash contributions in the amount of $3,231 to "Church" and to "various" in the amount of $182. Similarly, petitioners' 1980 California return lists cash contributions to "Church" in the amount of $5,000, cash contributions of $56 to "various" and non-cash donations of $150. Attached to petitioners' State income tax return for 1981 (which lists a cash contribution to "Church" in the amount of $3,148), was a letter from ULC-Wildwood, acknowledging petitioners' alleged contribution of $3,147.50. The 1981 return also lists various cash contributions in the amount of $59 and non-cash contributions of $105.

[7] The relevant provisions of sec. 170 are as follows:

> SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.
>
> (a) Allowance of Deduction.--
>
> (1) General Rule.--There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

(footnote continued)

(footnote continued from previous page)

* * *

> (c) Charitable Contribution Defined.--For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of--
>
> (1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made exclusively for public purposes.
>
> (2) A corporation, trust, or community chest, fund, or foundation--
>
> (A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;
>
> (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;
>
> (C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

* * *

v. Commissioner, 81 T.C. 272 (1983); *McGahen v. Commissioner*, 76 T.C. 468 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983).

Deductions are a matter of legislative grace and petitioners bear the burden of proving their entitlement to the claimed deductions. *Deputy v. duPont*, 308 U.S. 488 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). For the following reasons, we find that petitioners have failed to meet this burden.

First, petitioners have not produced any admissible evidence which would satisfy the substantiation requirements of section 170. Sec. 170(a)(1); sec. 1.170A-1(a)(2), Income Tax Regs. Moreover, we note that the record in this case is not entirely clear as to the nature or destination of petitioners' alleged charitable contributions. In their petition filed with this Court, petitioners contended that they had made contributions to ULC-Modesto, but only after they had written "to the Treasury Department and received a positive reply." Petitioners, however, did not produce any canceled checks or receipts evidencing contributions to ULC-Modesto. Instead, at trial, petitioners testified they they had made donations of cash and non-cash items (including beds, canes, wheelchairs, plants and landscaping materials, and hand-crafted items such as tables, mailboxes, and a pottery wheel) to Rippling River Center (the Center), a government facility for handicapped and disabled citizens.

Mr. and Mrs. Libby also testified that they held church services, counseled the Center's residents, and provided transportation which enabled many of the residents to attend medical evaluations. Mrs. Libby stated that some of the items were given by petitioners in conjunction with "the church," while other items were "purchased with church funds and then donated to the Center." Petitioners contended that these contributions were equal to or in excess of the amounts claimed on their 1979, 1980, and 1981 Federal income tax returns. Petitioners attempted to introduce receipts acknowledging their alleged contributions to the Center.[8] These consisted of letters signed by officers of the Citizens Association of Rippling River (the Association), as well as thank you notes written by individual residents. Three letters, one undated, were signed by former managers of the Center, acknowledging receipt of a stereo, flowers, and plants and thanking the petitioners for their acts of kindness and service to the Center residents. These receipts were not admitted into evidence at trial in this case under the rule against hearsay. See *Davis v. Commissioner*, *supra* at 814-815.

---

[8] Where a charitable contribution is made in property other than money, section 170 generally allows a deduction for the fair market value of the property at the time of the contribution. Sec. 1.170A-1(c), Income Tax Regs. The petitioners bear the burden of proving both the contributions and the fair market value of the property contributed. Rule 142(a), *Zmuda v. Commissioner*, 79 T.C. 714, 726 (1982) affd. 731 F.2d 1417 (9th Cir. 1984); see also sec. 1.170A-1(a)(2)(ii), Income Tax Regs. The petitioners here presented no proof as to the value of the alleged donations.

Second, petitioners have failed to establish that the alleged contributions were made to a qualified tax-exempt organization. Although petitioners introduced a canceled check in the amount of $100 made payable to ULC-Wildwood, in order for that contribution to be deductible, petitioners' local congregation must qualify as a tax-exempt organization under section 501(c)(3). The parties have stipulated that the charter congregation involved here was not a qualified tax-exempt organization and we agree.[9]

With respect to the alleged contributions made to the Center, petitioners have failed to establish that the alleged contributions were donated to or for the use of a state, possession of the United States or political subdivision thereof for exclusively public purposes as required by section 170(c)(1). Nor have petitioners established that the Association qualifies as a charitable recipient under section 170(c)(2). In this regard Ms. Thomas, resident manager during 1980 and 1981 and bookkeeper during 1979, testified that in order for a gift to be received by the Center, on behalf of the United States government, the receipt of that item or gift would have been specifically acknowledged by her as representative of the Housing Authority.

---

[9] Moreover, this Court has consistently held that the tax-exempt status of ULC-Modesto (prior to revocation of the Internal Revenue Service ruling) does not automatically encompass other Universal Life Church chartered "congregations." See, e.g., Brown v. Commissioner, T.C. Memo. 1986-268 and cases cited therein at n. 4.

However, Ms. Thomas testified that she was certain that neither the petitioners nor "their church" had made contributions or donations directly to the Center during the taxable years in issue, but if, in fact, gifts had been made, it was likely that they were given to individuals or to the Association, a group with no official authority to receive gifts on behalf of the Center. Mrs. Thomas stated that it was a common practice for citizens in the surrounding community to give gifts to individual residents. Gifts made for the benefit of specific individuals, however, are not deductible. Thomason v. Commissioner, 2 T.C. 441, 443 (1943). Furthermore, donations of personal services, even if made to qualified organizations, are not deductible. Grant v. Commissioner, 84 T.C. 809, 816 (1985), appeal filed (4th Cir., September 30, 1985). Only unreimbursed expenses incident to the rendition of services to a qualified charitable organization are deductible. Sec. 1.170A-1(g), Income Tax Regs.

Because petitioners have not substantiated the amounts of their claimed contributions nor shown that these contributions were made to a qualified tax-exempt organization, we conclude that they have failed to meet their burden of proof on the issue of deductibility. Therefore, we need not address the issue of whether any net earnings inured to the benefit of petitioners.

(2) Additions to Tax

Respondent has determined that petitioners are liable for additions to tax under section 6653(a). Section 6653(a)(1) provides for an addition to tax of five percent of any underpayment which is due to negligence or intentional disregard of rules or regulations. Section 6653(a)(2) provides for an addition to tax in an amount equal to 50 percent of the interest payable under section 6601 with respect to that portion of the underpayment due to negligence or intentional disregard of rules or regulations and for the period beginning on the last day prescribed by law for payment of the underpayment. See note 3, supra. Petitioners bear the burden of proof on this issue. Bixby v. Commissioner, 58 T.C. 757, 791 (1972); Enoch v. Commissioner, 57 T.C. 781, 802 (1972); Rule 142(a).

Petitioners introduced no evidence showing that their underpayment was not due to negligence or intentional disregard of rules and regulations. Petitioners' testimony that they stopped donating to the church in 1982 "because of the tax problems with the IRS" has no bearing on the years in issue here. We conclude that petitioners' underpayment of tax was due to negligence or intentional disregard of rules and regulations. Accordingly, we sustain respondent's determination with respect to the additions to tax under section 6653(a)(1). We also conclude, for purposes of the addition to tax under section

6653(a)(2), that all of petitioners' underpayment for 1981 was attributable to negligence or intentional disregard of rules and regulations.

We must next decide whether respondent's motion seeking damages under section 6673 should be granted.[10] We have considered the record in this particular case, and exercising our discretion, we have determined that damages pursuant to section 6673 will not be awarded in these proceedings.

Decision will be entered
for the respondent.

---

[10] Section 6673 provides:

> Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000.00 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as part of the tax.

Ju 11.7/2 : 1986-389

17

MF 214

T. C. Memo. 1986-389

ORIGINAL

UNITED STATES TAX COURT

ARTHUR AND VERNA JORDAN, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 12553-82. Filed August 20, 1986.

Arthur Jordan, pro se.

Bryan R. Sullivan, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, Judge: Respondent determined deficiencies in petitioners' Federal income taxes and section 6653(b)[1] additions to tax as follows:

---

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

Taxpayer	Year	Deficiency	Section 6653(b) Additions
Arthur Jordan	1973	$3,340.90	$1,670.45
	1974	3,950.11	1,975.06
	1975	6,982.43	3,491.21
Arthur and Verna Jordan	1976	5,503.00	2,751.50[2]

The issues for decision are (1) whether petitioners understated their income and overstated their deductions, resulting in underpayments of tax and (2) whether such underpayments were due to fraud on the part of petitioner Arthur Jordan.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

At the time the petition was filed, petitioners Arthur and Verna Jordan lived in Chicago, Illinois. Petitioner Arthur Jordan timely filed individual Federal income tax returns for 1973, 1974, and 1975. Petitioners Arthur and Verna Jordan timely filed a joint Federal income tax return for 1976. David Stover, a part-time tax return preparer, prepared the Federal income tax returns for 1973, 1974, and 1975. Stanley McGee prepared the income tax return for 1976.

---

[2] This addition to tax does not apply to Verna Jordan since respondent determined that no part of the underpayment was due to fraud on her part.

From 1953 through at least 1976, petitioner Arthur Jordan (hereinafter petitioner) was a patrolman with the Chicago Police Department. From 1969 through 1976, petitioner also owned and operated a six (or seven) unit rental apartment building at 7515-17 South Phillips in Chicago, Illinois. Petitioner had no other significant sources of income during the years in issue, but had some interest income and some small amounts of income from private security services performed during his off-duty hours.

In August of 1974, petitioner, who had been living in the seventh unit in the apartment building, moved out. With the exception of his use of that unit, all seven units were rented during all of the years before the Court, except for short vacancy periods between tenants. For each of the taxable years 1973, 1974, and 1975, petitioner reported $8,537 in gross rental income from the apartment building, although he raised the rent of some tenants each year. In 1976, petitioner reported $8,550 in gross rental income from the apartment building, although he raised the rent of several tenants that year. The tenants' rents were increased as their leases expired and as new leases were entered into. Petitioner personally negotiated the terms of the leases and had written leases with all tenants except his brother, Nathaniel. Petitioner never reimbursed or reduced rents to tenants for any maintenance or decorating performed by the tenants in their apartments. In nearly all instances, petitioner increased the monthly rental rates for leases signed in each of the years from 1969 through 1976. Petitioner personally collected the rents from his tenants. Also petitioner charged and collected a fee for all late payments of rent.

In 1973 the rents for the various units varied from $160 to $210 per month, with most of the units rented in the $200-205-210 range. In 1974 the rents varied from $185 to $230 per month, with most of the units rented in the $205-210-230 range. In 1975 the rents varied from $185 to $230 per month, with most of the units rented in the $215 to $230 range. In 1976 the rents varied from $190 to $230 per month, with most of the units rented in the $220-225-230 range. The rents were regularly and systematically increased by increments of $5 per rental unit.

From 1973 through 1976, petitioner received the following amounts of gross rental income from the apartment building and failed to report gross rental income as indicated below:

Tenants	1973	1974	1975	1976
Lawrence Smith and Ernestine Smith	$ 560.00	$2,415.00	$2,495.00	$2,595.00
Juanita Brown	2,175.00	975.00	-	-
Frankie Loggins and Charles Loggins	2,000.00	-	-	-
Christine Green and Bessie Williams	2,420.00	785.00	-	-
William Ballinger and Joyce Ballinger	1,810.00	-	-	-
Anna Lemons	2,485.00	2,535.00	2,610.00	2,720.00
Gregory C. Frazier	-	925.00	2,245.00	1,330.00
Nathaniel Jordan	-	1,380.00	2,760.00	2,760.00
Monica Mohammed	-	1,230.00	-	-
Ibrahim Abdurrahim	-	-	1,540.00	1,100.00
James Beard and Lillian Beard	-	-	-	1,545.00
Howard Ball and Lillie M. Ball	-	-	1,100.00	2,670.00
Mossie L. Coley	-	-	1,540.00	2,690.00
Frank H. Becton and Betty Becton	-	-	-	1,095.00
Rodney Surratt and Stephanie D. Surratt	400.00	2,420.00	1,460.00	-
William Shaw and Mary Shaw	2,460.00	2,580.00	1,320.00	-
Total rents paid to petitioner	$14,310.00	$15,245.00	$17,070.00	$18,505.00
Gross rental income reported on tax return	8,537.00	8,537.00	8,537.00	8,550.00
Unreported gross rental income	$ 5,773.00	$ 6,708.00	$ 8,533.00	$ 9,955.00

Petitioner claimed deductions for gas heating expenses at the apartment building of $4,000 each year for 1973 and 1974 and $4,768 for 1976. Petitioner paid Peoples Gas only $1,202.96, $1,634.05, and $2,333.68 in 1973, 1974, and 1976, respectively, for such gas heating expenses. Petitioner thus overstated his deductions for gas heating expenses by the amounts of $2,797.04, $2,365.95, and $2,434.32, respectively, for those years. For each year 1974, 1975, and 1976, petitioner claimed $120 of depreciation deductions for a central air conditioning unit allegedly installed at the apartment building in January 1974. However, the air conditioner had not been installed at the apartment building, but had been installed at petitioner's personal residence at 9152 S. Kingston.

Petitioner reported $2,791.12 and $2,579.94 in interest income from First Federal Savings and Loan in Chicago in the 1974 and 1975 tax years, respectively. Petitioner received $2,907.09 and $3,585.32 in interest income from First Federal Savings and Loan in 1974 and 1975, respectively. Petitioner understated his interest income by the amounts of $115.97 and $1,005.38, respectively, for those years.

During the years in issue, petitioner claimed the following interest expense deductions on Schedule A of his returns:

	1973	1974	1975	1976
John M. Smyth Co.	$135.00	$135.00	$135.00	$115.00
Richard B. Zarbin & Assocs.	245.00	245.00	242.00	-
Sears, Roebuck & Co.	-	270.00	270.00	-

Petitioner did not pay any interest to John M. Smyth Co. or Richard B. Zarbin & Associates during the years at issue. Petitioner paid Sears, Roebuck & Co. only $10.26 and $38.05 in interest during the taxable years 1974 and 1975, respectively. Petitioner thus overstated his Schedule A interest deductions by the amounts of $380, $639.74, $608.95, and $115, respectively, for the years before the Court.

In 1973 petitioner claimed a Schedule A itemized deduction of $796.22 for medical expenses allegedly incurred while he was hospitalized at Jackson Park Hospital that year. Petitioner was not hospitalized at Jackson Park Hospital during 1973. His wife, who filed a separate return, was hospitalized there in 1973, but the bill was paid by Blue Cross except for $9.50.

Petitioner claimed deductions of $700 and $550 for charitable contributions to the Union Central Missionary Baptist Church in Chicago for 1973 and 1974, respectively. Attached to petitioner's 1973 return was a document that purported to be a receipt from the Union Central Missionary Baptist Church signed by one Mary George, church clerk. During the audit petitioner submitted another such receipt for 1974 purportedly signed by Mary George. Mary George did not sign either of these receipts, and the receipts did not come from the church. Petitioner did not make any contributions to the Union Central Missionary Baptist Church during 1973 or 1974. Petitioner knowingly attempted to substantiate both of these claimed contributions with forged receipts.[3]

---

[3] The record is not wholly clear as to whether petitioner or his return preparer forged these receipts, but if the return preparer forged them, he did so with petitioner's knowledge and at petitioner's direction. Mr. Stover, the return preparer, testified that petitioner first saw a similar receipt on his (Stover's) desk and told Stover "to make one of those things out for me." While the Court cannot condone such actions, the Court believed Mr. Stover's testimony.

Petitioner played an active role in the preparation of each year's tax return. Petitioner either told the return preparer what figures to put on the return or he presented him a bag containing various receipts, many from prior years. Year after year petitioner presented many of the same receipts to his return preparer to use in the preparation of his returns. Petitioner frequently told his return preparer, David Stover, to change figures when the tax was too high. Petitioner would come back to Stover's house two or three times to tell him to change the return, saying "Stover, this is not enough money for me. I want all of my money back." Stover changed the return and put in whatever figures petitioner wanted.[4]

In early 1976, Carolyn McCollough, a tax auditor with the Internal Revenue Service, was assigned to audit petitioner for the 1973 and 1974 taxable years. In September 1977, Internal Revenue Service Special Agent Gordon Meyer commenced to investigate petitioner for criminal violations for the taxable years 1973 through 1976. In both investigations, petitioner was uncooperative, refusing to produce documents, lying to the agents, or producing forged or fraudulent documents. Petitioner refused to provide certain documents or account for their absence.[5]

---

[4] Petitioner tried to suggest that he gave his return preparer all of his records and simply depended on him to prepare a proper return and signed the return thus prepared without reviewing it. The Court did not believe petitioner's testimony and found the testimony of Mr. Stover more credible.

Petitioner lied to Carolyn McCollough about numerous matters. He told her he had reported all of his rental receipts. He told her that he frequently reduced a tenant's rent if the tenant repaired the apartment, this statement being made to explain the uneven amounts shown in certain rent receipt stubs he produced during the audit. The rent was never reduced under such circumstances. Also the rent receipt stubs totalled less than the amounts reported on the returns, and the amounts reported on the returns totalled far less than the rents petitioner actually received. Petitioner told Ms. McCollough that the rents averaged about $115 per month in 1973 up to about $150 per month in 1976. This was false and petitioner, who personally negotiated the leases and personally collected the rents, knew it was false. Petitioner told Ms. McCollough that he never used leases in the apartment building. The record contains copies of eight leases signed by the petitioner, and all of the tenants, except petitioner's brother, had a written lease.

In both investigations, petitioner used forged documents to justify deductions for charitable contributions and medical expenses. The forged receipts from the Union Central Missionary

---

[5] We did not believe petitioner's testimony that the records of rent receipts were either stolen in a 1976 burglary or destroyed in a fire in 1977 or 1978. Moreover, these convenient mishaps appear to have occurred after the documents were requested.

Baptist Church have been discussed above. In addition petitioner presented documents purportedly from the Jackson Park Hospital allegedly signed by a Mrs. Stewart, Registrar. Petitioner told the special agent he personally obtained that letter from the hospital and that he paid the amounts stated in the letter. There was no Mrs. Stewart and no position of registrar at the hospital. The letter was a forgery and petitioner lied about it. Petitioner also lied to both investigators, stating that certain expenses were incurred at the apartment building, when in fact they were personal expenses incurred at his private residence or were just estimates for work that was never performed at all. One estimate for work that was never performed had been altered to change the figure from $145 to $1,145, but petitioner lied during the audit saying that the work had been performed at the apartment building and that he had paid the $1,145.

In January 1980, petitioner was indicted on four counts of violating section 7206(1) for 1973, 1974, 1975, and 1976. On April 10, 1981, petitioner entered a guilty plea to counts 2 and 3 for the years 1974 and 1975. Petitioner pleaded guilty to willfully and knowingly filing false returns for those years, one falsity being that he reported total rents received of $8,537 each year when he well knew and believed that the total amount of rents each year was substantially in excess of that figure. The other falsity was overstating charitable contributions and interest expense deductions when he well knew and believed that he was not entitled to the deductions. The charges for 1973 and 1976 were dismissed.

ULTIMATE FINDINGS OF FACT

Petitioner substantially underpaid his taxes each year and such underpayments were due to fraud.

OPINION

The normal split burden of proof applies in this fraud case. Zack v. Commissioner, 692 F.2d 28 (6th Cir. 1982), affg. a Memorandum Opinion of this Court, cert. denied 460 U.S. 1084 (1983). Respondent's determinations of deficiencies are presumptively correct, and the taxpayer has the burden of proving error in them. Welch v. Helvering, 290 U.S. 111, 115 (1933); Rule 142(a). Respondent bears the burden of proving the taxpayer's fraud by clear and convincing evidence. Sec. 7454(a); Rule 142(b). Stone v. Commissioner, 56 T.C. 213, 220 (1971). Respondent must establish that the taxpayer underpaid his taxes in some amount each year and that some part of the underpayment each year was due to fraud. Hebrank v. Commissioner, 81 T.C. 640, 642 (1983); Plunkett v. Commissioner, 465 F.2d 299, 303 (7th Cir. 1972).[6] In meeting his burden of showing an underpayment of tax, respondent cannot rely upon the taxpayer's failure to sustain his burden in regard to the deficiencies. Drieborg v. Commissioner, 225 F.2d 216, 220 (6th Cir. 1955); Estate of Beck v. Commissioner, 56 T.C. 297, 363 (1971).

In this case petitioners have failed to meet their burden of proof on the deficiency determinations. Wholly apart from their failure of proof, there is clear and convincing evidence in the record of understated income and overstated deductions that amply establishes an underpayment of tax each year. Respondent must further establish by clear and convincing evidence that these underpayments were due to fraud on the part of petitioner Arthur Jordan (hereinafter petitioner).

---

[6] See also Meredith v. Commissioner, T.C. Memo. 1985-170; Patton v. Commissioner, T.C. Memo. 1985-148; Phillips v. Commissioner, T.C. Memo. 1984-133.

Fraud under section 6653(b) requires a specific intent on the part of the taxpayer to evade a tax believed to be owing. Candela v. United States, 635 F.2d 1272 (7th Cir. 1980); Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); Mitchell v. Commissioner, 118 F.2d 308 (5th Cir. 1941), revg. 40 B.T.A. 424 (1939), followed on remand 45 B.T.A. 822 (1941); Wilson v. Commissioner, 76 T.C. 623, 634 (1981), Supplemental Opinion 77 T.C. 324 (1981). Respondent must prove that the taxpayer intended to evade taxes by conduct calculated to conceal, mislead, or otherwise prevent the collection of the taxes. Stoltzfus v. United States, supra, 398 F.2d at 1004; Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Acker v. Commissioner, 26 T.C. 107, 112-113 (1956).

Fraud is a question of fact that is determined on the basis of the entire record. Mensik v. Commissioner, 328 F.2d 147, 150 (7th Cir. 1964), cert. denied 389 U.S. 912 (1967), affg. 37 T.C. 703 (1962); Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978); Otsuki v. Commissioner, 53 T.C. 96, 105-106 (1969). Fraud can seldom be established by direct proof of the taxpayer's intention; therefore the taxpayer's entire course of conduct must be considered, and fraudulent intent can be established by circumstantial evidence. Spies v. United States, 317 U.S. 492 (1943); Gajewski v. Commissioner, supra, 67 T.C. at 200; Stone v. Commissioner, supra, 56 T.C. at 223-224; Otsuki v. Commissioner, supra, 53 T.C. at 105-106. Respondent must prove fraud in each of the years before the Court. Drieborg v. Commissioner, supra, 225 F.2d at 220.

Petitioner, a Chicago policeman, owned and personally operated a rental apartment building. He personally negotiated the leases with his tenants and personally collected the rents (including charges for any late payments). He raised the rents each time a lease was renewed or a new tenant moved in. In the four years before the Court, petitioner reported essentially the same amount of gross rental income each year and substantially understated his gross rental income each year in an increasing amount. A pattern of understating income over several years is strong evidence of fraud. Merritt v. Commissioner, 301 F.2d 484, 487 (5th Cir. 1962); Vannaman v. Commissioner, 54 T.C. 1011, 1018 (1970).

Similarly, a pattern of substantial overstatements of deductions supports a finding of fraud. Hicks Co. v. Commissioner, 56 T.C. 982, 1019 (1971), affd. 470 F.2d 87 (1st Cir. 1972); Neaderland v. Commissioner, 52 T.C. 532, 540 (1969), affd. 424 F.2d 639 (2d Cir. 1970), cert. denied 400 U.S. 827

(1970). Here, petitioner overstated his rental expenses and various Schedule A itemized deductions. Petitioner treated personal expenses, an air conditioner installed at his home, as a rental business asset and improperly claimed depreciation on it. Petitioner claimed business expense deductions for other personal expenditures and for estimates for work that was never performed. Petitioner deducted charitable contributions, a medical expense, and interest deductions that he knew he was not entitled to, not having made the contributions to the church, not having been hospitalized as he claimed, and not having paid the interest. Petitioner also prepared or caused to be prepared altered, forged, and fraudulent documents that he submitted to respondent to try to substantiate these various improper deductions.

Moreover, for two of the years before the Court, 1974 and 1975, petitioner pleaded guilty to charges under section 7206(1). In Wright v. Commissioner, 84 T.C. 636 (1985), this Court held a conviction (after trial or on a guilty plea) under section 7206(1) does not collaterally estop the taxpayer from contesting fraud under section 6653(b), since intent to evade tax is not an element of the crime charged under section 7206(1). The conviction is, however, highly relevant to the issue in this case. Petitioner is estopped to deny that he willfully filed false returns in 1974 and 1975 and that the falsity was that he reported rental income of only $8,537 each year whereas he well knew and believed that the total amount of rents was substantially in excess of that figure and that he claimed deductions that he well knew and believed he was not entitled to. Wright v. Commissioner, supra; Considine v. United States, 683 F.2d 1285, 1287-1288 (9th Cir. 1982) (Considine III); Considine v. United States, 645 F.2d 925, 931-932 (Ct. Cl. 1981) (Considine II).[7] These factors can be considered as additional evidence of petitioner's fraudulent intent.

Finally, petitioner failed to cooperate during the investigation of his tax returns. A failure to cooperate with respondent's attempt to determine his correct tax liability can be a further indicium of fraud. Millikin v. Commissioner, 298 F.2d 830, 836 (4th Cir. 1962); Powell v. Granquist, 252 F.2d 56, 60-61 (9th Cir. 1958); Rowlee v. Commissioner, 80 T.C. 1111, 1125 (1983). Here petitioner failed or refused to produce certain records, lied to respondent's agents on a number of occasions about a number of matters, and produced altered, forged, and fraudulent documents to try to mislead them. Petitioner's false and misleading statements and other misconduct during the audit are telling "badges" of fraud in this case.

---

[7] See also Piazza v. Commissioner, T.C. Memo. 1985-222.

The evidence clearly and convincingly establishes that petitioner underpaid his taxes in 1973, 1974, 1975, and 1976 and that the underpayments were due to fraud. Petitioner Arthur Jordan is liable for the section 6653(b) fraud addition.

To reflect the foregoing,

Decision will be entered
under Rule 155.[8]

---

[8] The evidence shows understated rental income for 1974 and 1975 in amounts slightly less than and for 1976 in an amount slightly greater than the amounts set forth in the statutory notice of deficiency. Respondent has not sought an increased deficiency for 1976, but has asked the Court to find the lower taxable income amounts for 1974 and 1975. For that reason only, decision will be entered under Rule 155, as respondent requested in his brief.

712-B Ju 11.7/2:1986-390

11

rd 214

T. C. Memo. 1986-390 ORIGINAL

UNITED STATES TAX COURT

STEPHEN A. MILLER AND BARBARA J. MILLER, ET AL.,[1] Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 14478-82, 19772-83, 25793-83.

Filed August 20, 1986.

Daniel J. Winfree, for petitioners.

Karen Nicholson Sommers, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined deficiencies in and additions to petitioners' income taxes as follows:

---

[1] Cases of the following petitioners are consolidated herewith: Tracy Bischof and Arlyne Bischof, docket No. 19772-83; and James A. Palmer and Karen T. Palmer, docket No. 25793-83.

Petitioners	Year	Deficiencies	Additions to Tax Section 6653(a)[2]
Stephen A. Miller	1978	$ 7,196.00	---
and Barbara J. Miller	1979	14,445.00	---
Tracy Bischof	1978	6,393.00	$320.00
and Arlyne Bischof	1979	8,116.00	406.00
	1980	8,804.00	---
James A. Palmer	1979	5,830.00	269.00
and Karen T. Palmer	1980	8,732.00	---
	1981	6,218.00	---

After concessions, the issues remaining for decision are what amounts, if any, are petitioners entitled to deduct for depreciation under section 167 and to claim as credits under section 48(a) because of their investments in certain lithograph plates.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and exhibits attached thereto are incorporated herein by reference.

Petitioners Stephen A. Miller and Barbara J. Miller, husband and wife, resided in Granada Hills, California, at the time they filed their petition. They filed joint income tax returns for the years 1978 and 1979. Stephen was a sales manager for a scientific instrument company and Barbara was a housewife during the years 1978 and 1979.

---

[2] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

Petitioners Tracy Bischof and Arlyne Bischof, husband and wife, resided in El Cajon, California, when they filed their petition. They filed joint income tax returns for the years 1978, 1979, and 1980. Tracy was a retailer of dental ceramics and Arlyne was a housewife from 1978 through 1981.

Petitioners James T. Palmer and Karen A. Palmer, husband and wife, resided in La Mesa, California, at the time they filed their petition. They filed joint income tax returns for the years 1979, 1980, and 1981. James was a junior college instructor and Karen was a teacher during the years 1979 through 1981.

Multiple Graphics Enterprises ("Multiple Graphics") was incorporated in California on July 1, 1979, by George W. Petropoulos and David L. Kagel to acquire and resell lithograph plates. Petropoulos and Kagel each owned 50 percent of the stock of Multiple Graphics in 1979 and 1980 and were its principal officers and directors. Neither of them had any experience in the marketing of art prior to their formation of the corporation. They did, however, consult to a limited extent with Herbert Hamrell, the owner of an art gallery.

On October 1, 1979, Multiple Graphics entered into an agreement with Herbert Fink, an artist, under which Fink agreed to produce 29 lithograph plates and transfer them together with all related rights to Multiple Graphics. On December 31, 1979, Fink transferred the 29 plates and related rights to Multiple Graphics for the sum of $72,500, or $2,500 per plate. During 1979, Multiple Graphics offered to sell undivided one-half interests in each of the 29 plates for a total of $50,000. Each prospective purchaser received an offering memorandum from Multiple Graphics. The memorandum emphasized that the art business was highly speculative and that a purchase of the plates "should be considered only by a person who can afford total loss of his purchase price." Prospective purchasers were also informed by the memorandum that Multiple Graphics had no experience in the art business.

Most of the memorandum was addressed to the tax implications of the promotion. The tax implications were also discussed in an opinion letter that accompanied the memorandum. Neither the memorandum nor the opinion letter contained any discussion of the income to be earned from the plates. The only projection concerned the tax savings that could be received by an individual buying a 50 percent interest in one of the plates. This projection appeared in the memorandum in a schedule titled "Projected Results/Purchase of Etching," and purportedly demonstrated how a cash investment of $11,000 by a taxpayer in the 50 percent tax bracket would yield a total tax savings of $29,900. Directly beneath the title of this schedule, projected income was shown as follows: "(Projected Income = $.0)."

Petitioners Miller and Bischof became aware of the promotion through Tax and Business Services, an accounting firm that performed tax services for all petitioners. The accounting firm also represented Multiple Graphics and was involved in the promotion. Petitioner Palmer learned of the promotion from Petropoulos.

In November and December of 1979, petitioners Miller, Palmer, and Bischof each purchased a 50 percent interest in a separate plate. Petitioners Miller and Bischof each paid $10,000 cash and executed a $40,000 "recourse" promissory note. Petitioner Palmer paid $6,400 cash and executed a $43,600 "recourse" promissory note. All petitioners agreed to pay Multiple Graphics 50 percent of the gross receipts from any sales of prints from their plates. Such payments were to be applied to the balance due on the notes. Each note was payable in full in 10 years and at maturity could be satisfied, at least partially, by petitioners' tendering to Multiple Graphics any unsold prints.[3]

Petitioners did not have the plates appraised before their purchase and petitioners were not furnished with an appraisal by Multiple Graphics. Petitioners did not discuss the plates with any art experts, but petitioner Palmer did ask an art teacher with whom he worked what she thought about his plate.

After the plates were purchased by petitioners, Multiple Graphics had Fink produce 300 prints from each plate. The prints were placed in storage by Multiple Graphics in Los Angeles on May 1, 1980.

On June 19, 1980, petitioners met with Multiple Graphics. The purpose of the meeting which was arranged by Multiple Graphics was to introduce petitioners and other purchasers of plates to Graphic Distribution Services ("Graphic Distribution"), a corporation which had been formed two months earlier to market the prints. Hamrell and Kagel were the officers of Graphic Distribution, but Petropoulos was introduced at the meeting as one of its principals. Its address was the same as the address of Multiple Graphics.

---

[3] Petitioners were to be given credit for 50 percent of the retail selling price of the unsold prints.

At the meeting and in follow-up letters, Petropoulos urged petitioners and the other purchasers of plates to appoint Graphic Distribution as the distributor of their prints. All of petitioners did so during July and August of 1980. The distribution agreements provided that Graphic Distribution would market the prints in exchange for 25 percent of the gross receipts plus expenses of up to $250 per year.

On May 11, 1981, petitioners received an unsigned "Progress Report" stating that Graphic Distribution was "working diligently to get a sales organization in place and to develop print sales at a level commensurate with the sustainable tax validity of your investment." No sales of prints were made during 1981.

On November 2, 1981, Philip Miller, the brother of petitioner Stephen Miller, took control of Graphic Distribution by purchasing all of its stock and naming himself its president and his wife vice president and secretary. Neither he nor his wife had any prior experience in marketing prints; and to the date of trial, Graphic Distribution had made few, if any, sales and petitioners had received no income from their investments in the plates and had kept no records with respect thereto.

OPINION

Petitioners contend that with respect to their lithograph plates they are entitled to deductions for depreciation under section 167 and to investment credits under section 48(a) because the plates were acquired and used by them in a trade or business. Respondent contends that petitioners are not entitled to depreciation deductions or investment tax credits because petitioners' activities did not constitute a trade or business.[4] We agree with respondent.

Section 167(a) allows a deduction for depreciation with respect to property used in a trade or business[5] and section 48(a) allows an investment tax credit with respect to certain personal property that qualifies for depreciation under section 167(a). Consequently, in this case both the deductions for depreciation and the investment credits depend upon whether or not petitioners' plates were used in a trade or business.

The phrase "trade or business" as used in section 167(a) is to be interpreted in the same manner as the phrase is used in section 162(a). Richmond Television Corp. v. United States, 345 F.2d 901, 909 (4th Cir. 1965), remanded on other grounds 382 U.S. 68 (1965); Brannen v. Commissioner, 78 T.C. 471, 501 (1982), affd.

---

[4] Respondent advanced other arguments, but we find it unnecessary to address them in light of our decision on this issue.

[5] Section 183 allows depreciation deductions and investment credits with respect to certain property used in an activity which does not constitute a trade or business but only to the extent the activity generates income. In this case it is admitted that there was no income from the activity; therefore, petitioners must rely only on section 167(a).

722 F.2d 695 (11th Cir. 1984). To constitute the carrying on of a trade or business under section 162, an activity must "be entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963), affg. a Memorandum Opinion of this Court. See also Hager v. Commissioner, 76 T.C. 759, 784 (1981), and the cases cited therein. The expectation of a profit need not be a reasonable one. It is sufficient if there is a bona fide objective of making a profit. Fox v. Commissioner, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984), affd. without published opinions sub nom. Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner, 734 F.2d 5-7, 9 (3d Cir. 1984); Hager v. Commissioner, supra. Whether there is an intention to make a profit is one of the facts to be resolved from all the surrounding circumstances. Golanty v. Commissioner, 72 T.C. 411, 426 (1979), affd. in an unpublished opinion 647 F.2d 170 (9th Cir. 1981); Dunn v. Commissioner, 70 T.C. 715, 720 (1978), affd. 615 F.2d 578 (2d Cir. 1980).

The burden of proof with respect to the requisite intention is on petitioners. Rule 142(a); Golanty v. Commissioner, supra at 426. In making the determination as to intent, objective facts are to be given greater weight than the parties' statements of their intent. Fox v. Commissioner, supra at 1007.

In Golanty v. Commissioner, supra, we set forth a list of factors that have been considered relevant in previous cases to a determination of whether an activity was entered into for profit. We find that the following factors from that list are relevant to the cases before us: (1) The manner in which the activity was conducted; (2) the expertise of the taxpayers or their advisors; (3) the time and effort expended by the taxpayers in carrying on the activity; (4) the expectation that the assets would appreciate in value; (5) the taxpayers' history of income or losses with respect to the activity; and (6) the amount of profits, if any, which were earned.

The first, and perhaps most important, factor to be considered in these cases is the manner in which the activity was conducted. The record as a whole reveals that petitioners in each case acted in a nonbusinesslike manner and were not concerned with making a profit. To begin with, they purchased the plates without having any idea of their worth and without attempting to obtain appraisals. At the time of purchase, petitioners did not know what price, if any, the prints would sell for, how long it would take to sell the prints, what state the art market was in, or how the artist's work was regarded. The only projection that petitioners had was a schedule of anticipated tax savings, and this schedule, provided by the promoter, assumed that the income from the prints would be zero. The offering memorandum was devoted almost entirely to the tax implications of the promotion and contained no discussion of possible profits. In sum, from the offering and at the time the plates were purchased, petitioners knew only one thing, i.e., if the statements made in the offering were correct, the plates would result in large tax savings to petitioners.

Petitioners and their co-owners also agreed to pay $100,000 for plates that Multiple Graphics had just paid $2,500. Their purchase price represented an incredible 4000 percent increase over Multiple Graphics' cost.

Petitioners' actions after the plates were purchased further reflect their indifference to a profit. At the urging of Multiple Graphics, petitioners chose to market their prints through Graphic Distributions--a corporation that had been in existence for only two months and had two of the same principals as Multiple Graphics. Petitioners were also aware that these two principals, Petropoulos and Kagel, had no experience in the art world.

After more than a year without any sales, the other principal, Hamrell, who had limited art experience, was replaced by the brother of petitioner Stephen Miller, but the brother was "starting a new career" and this change added nothing to the prospects for petitioners' investments.

With respect to the other factors listed in Golanty v. Commissioner, supra, the record clearly reflects the following: (1) petitioners expended little effort in marketing their prints; (2) there was no supportable expectation by petitioners that their prints or plates would ever appreciate in value; and (3) their investments yielded no gross income during the four years in issue. In fact, the record fails to reveal the sale of even one print prior to trial.

We conclude, therefore, that petitioners' activities with respect to their plates were engaged in solely for the purpose of reducing their income taxes and were not engaged in for profit and did not constitute a trade or business. See Knetsch v. United States, 364 U.S. 361 (1969). Consequently, petitioners are not entitled to depreciation deductions or investment credits with respect to the plates.[6]

Decision will be entered under Rule 155.

---

[6] Even if petitioners' activities qualified as a trade or business, petitioners have not established that their plates have determinable useful lives, another prerequisite for depreciation deductions under section 167(a). Section 1.167(a)-1(a) and (b), Income Tax Regs.; Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1,12 (1979).

323

742-B

Ju 11.7/2: 1986-391

COMPLETED

7

MR216

ORIGINAL

T. C. Memo. 1986-391

UNITED STATES TAX COURT

NEIL C. HYSLEP AND ANN A. HYSLEP, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9064-84. Filed August 25, 1986.

Neil C. Hyslep, pro se.

Gioele Settembrini, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

COUVILLION, Special Trial Judge: This case was assigned pursuant to the provisions of section 7456(d) of the Code[1] and Rules 180, 181, and 182.

Respondent determined a deficiency in petitioners' Federal income tax for 1980 in the amount of $2,774, and an addition to tax under section 6653(a) in the amount of $138.70. The issues for decision are whether petitioners are entitled to deduct expenses incurred while away from home under section 162(a)(2); and whether petitioners are liable for the addition to tax under section 6653(a) for negligence or intentional disregard of rules and regulations.

---

[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated; and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners resided in Jacksonville, Florida, at the time the petition herein was filed.

Neil C. Hyslep (petitioner) is an electrical construction worker who, for over 35 years, was affiliated with the International Brotherhood of Electrical Workers (IBEW). As a member of IBEW, petitioner received work assignments out of the local office to which he belonged by referral to an employer utilizing his skills. In late 1979, petitioner was referred to IBEW Local 328 in West Palm Beach, Florida, where he was informed, in September 1979, that work was available in the construction of a nuclear power plant on a small island near Jensen Beach, Florida. Petitioner contracted with the contractors listed below and thereafter performed labor at the nuclear power plant site as follows:

9/17/79 - 1/21/80	-	EBASCO Services, Inc.
3/24/80 - 7/31/80	-	EBASCO Services, Inc.
8/11/80 - 12/13/80	-	EBASCO Services, Inc.

At the times petitioner was hired, he was not informed as to the length of his employment and was aware that he could be laid off at any time. He was also aware that the construction project would take many years, and he could be employed there for some time. During 1980, petitioner was laid off three times but was rehired shortly thereafter. He continued his work during 1981, 1982, and 1983; however, as in 1980, petitioner was laid off and rehired several times during those years.

During 1980, petitioner rented a lot and maintained a mobile home in Jensen Beach, Florida, but continued to maintain a residence with his wife in Jacksonville, Florida. During 1980, petitioner returned to his residence on weekends, a distance of 262 miles.

Petitioners, on their 1980 Federal income tax return, deducted $10,110.78, as expenses in maintaining their mobile home in Jensen Beach, Florida, and for petitioner's expenses in driving to and from Jacksonville, Florida each weekend.

Respondent disallowed the claimed deduction, on the basis that petitioner was not "away from home" under section 162(a)(2). Upon review of the record, we agree.

OPINION

Section 162(a)(2) allows a taxpayer to deduct traveling expenses, including amounts expended for meals and lodging, if such expenses are: (1) ordinary and necessary; (2) incurred while "away from home;" and (3) incurred in the pursuit of a trade or business. Commissioner v. Flowers, 326 U.S. 465, 470 (1946); Bochner v. Commissioner, 67 T.C. 824, 827 (1977). To determine whether petitioners' expenses were deductible under section 162(a)(2), a determination must be made whether he was "away from home."

The determination of whether a taxpayer is "away from home" turns on whether the employment at the distant location was temporary or indefinite. See Peurifoy v. Commissioner, 358 U.S. 59 (1958), and cases cited therein. If the employment was temporary, the taxpayer's tax home is his primary residence; where a taxpayer's employment was indefinite, the taxpayer's tax home, within the purview of section 162(a)(2), is where the indefinite job was located. Kroll v. Commissioner, 49 T.C. 557, 562 (1968). That is to say, once a job has been determined to be indefinite, the job is considered to be the taxpayer's principal employment and his tax home is where the principal place of employment is located. Expenses incurred at a taxpayer's tax home are not deductible under section 162(a)(2) because they are not incurred "away from home" and are considered nondeductible, personal expenses. See section 262.

Whether petitioner's employment was temporary or indefinite is a question of fact. Schurer v. Commissioner, 3 T.C. 544, 546 (1944), cited with approval in Peurifoy v. Commissioner, supra at 61. The burden of proof is upon the petitioners. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933).

A taxpayer may discharge his burden of proof by showing that employment at the location in question was such that "termination within a short period could be foreseen." Albert v. Commissioner, 13 T.C. 129, 131 (1949). Conversely, a taxpayer fails to carry his burden if the evidence indicates that the employment was indefinite, i.e., "its termination [could not have been] foreseen within a fixed or reasonably short period of time." Stricker v. Commissioner, 54 T.C. 355, 361 (1970), affd. 438 F.2d 1216 (6th Cir. 1971). Even if it is known that the employment will terminate within a fixed time, it is not temporary if it is expected to last for a substantial or indefinite period of time. Jones v. Commissioner, 54 T.C. 734 (1970), affd. 444 F.2d 508 (5th Cir. 1971); Norwood v. Commissioner, 66 T.C. 467 (1976). See also Kroll v. Commissioner, supra.

We find petitioners have failed to prove that the employment in question was temporary and not indefinite. Petitioners argued that, by the very nature of petitioner-husband's line of work, construction work, his work assignments were temporary. We recognize that standing alone petitioner's job assignments at times lasted for short durations, however, taken in the aggregate, petitioner was employed at the nuclear plant at least three years. Each time he was laid off, he was rehired shortly thereafter. He admits he never knew when he would be laid off. The job could last a day or a year. Petitioner, however, expected employment at the plant for several years and was in fact so employed. Petitioner must demonstrate that he had a reasonable expectation of being terminated within a short time.[2] Considered in the aggregate, the facts and circumstances do not support a conclusion that petitioner's employment could reasonably have been expected in 1980 to terminate within a short time. Therefore, we hold for respondent.

Section 6653(a) provides for the imposition of an addition to tax for an underpayment of tax due to negligence or intentional disregard of rules and regulations.

Petitioners bear the burden of proof on this issue. Welch v. Helvering, supra; Rule 142. In this case, we find that petitioners have carried their burden; therefore, the addition to tax is disallowed.

At trial, respondent conceded that certain amounts claimed by petitioners and disallowed by respondent were in fact properly allowable under section 162(a). Therefore, expenses in the amounts of $87.99 and $712.81, representing expenses incurred for protective clothing and employment fees, respectively, are allowed.

---

[2] Broome v. Commissioner, T.C. Memo. 1985-321.

Decision will be entered under Rule 155.

323

742-13

Ju 11. 7/2: 1986-392
COMPLETED
9

M214

ORIGINAL

T. C. Memo. 1986-392

UNITED STATES TAX COURT

ROY J. NORMAN AND MARILYN F. NORMAN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19905-84. Filed August 25, 1986.

Roy J. Norman, pro se.

Byron Calderon, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, *Judge*: Respondent determined a deficiency and an addition to tax in petitioners' Federal income tax for the taxable year 1979 as follows:

Deficiency	Addition to Tax Sec. 6653(a)[1]
$544.00	$27.00

---

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

The issues for determination are (1) whether petitioners received unreported income during the taxable year in issue and (2) whether petitioners are liable for the addition to tax under section 6653(a) due to negligence or an intentional disregard of rules or regulations.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by reference.

Petitioners resided within the state of Colorado when they filed their petition in this case.

Petitioner[2] was employed as a revenue officer with the Internal Revenue Service during the taxable year in question.

On February 2, 1977, Pay-Center, Inc. secured a judgment against Frank A. James ("James") for the amount of $437.08. On June 3, 1977, James executed a Deed of Trust on certain real property to secure to East Continental Industrial Bank ("Bank") the payment of $134,999.41. The properties secured were Lot 98, Green Valley Ranch Unit 1, and Lots 29 and 30, Green Valley Ranch Unit 2 ("the Property").

On May 31, 1978, the Bank foreclosed on the mortgage and at public sale purchased the Property for $2,318.06. On August 22, 1978, Imogene L. Justus purchased the property for $2,334.76 from the Bank. On September 1, 1978, Justus deeded the Property by quit-claim deed to Edytha L. Lesuer ("Lesuer") and several other Lesuer family members. On December 7, 1978, petitioner paid Pay-Center, Inc. the sum of $228 for the assignment of its $437.08 judgment against James. The judgment was a priority lien.

---

[2] "Petitioner" in the singular form hereinafter refers to petitioner Roy J. Norman.

At the direction of petitioner, a Writ of Execution was issued on December 11, 1978, directing the Sheriff of Jefferson County to satisfy the judgment against James held by petitioner. The Sheriff levied upon, seized and took into his possession the Property. On February 6, 1979, the Property was offered for sale at public auction. Petitioner, as assignee of Pay-Center, Inc., was declared the highest and best bidder. The Sheriff's fees for the public auction were $67.37 of which petitioner paid $59.75. Petitioner became owner of the property by warranty deed on April 25, 1979.

On May 21, 1979, petitioner conveyed good title to the Property by Quit-Claim deed to Lesuer. Petitioner received a personal check from Lesuer dated June 18, 1979, in the amount of $2,000. Petitioner negotiated Lesuer's check and executed and delivered a receipt dated June 18, 1979, reflecting the payment of $2,000 as payment "in full" for the Property.

On September 12, 1979, petitioner filed a warranty deed in the land records of Jefferson County, Colorado, deeding the Property from petitioner as assignee to petitioner as an individual. On March 13, 1980, petitioner deeded the Property from himself to Lesuer by Warranty Deed. On August 27, 1980, the

Jefferson County Land Records show that petitioner and Lesuer deeded the Property to petitioner by warranty deed. Only petitioner's signature appears on the August 27, 1980, deed.

On January 26, 1981, petitioner filed a Quiet Title Action against Lesuer in the District Court of Jefferson County, Colorado, requesting the title to the Property be quieted in petitioner's name. On April 8, 1983, the District Court decreed that Lesuer was the owner of the Property in fee simple by virtue of the Quit Claim deed dated May 21, 1979. Moreover, the District Court of Colorado found that the $2,000 personal check from Lesuer to petitioner dated June 18, 1979, represented the full payment for the Property.

In January of 1983, petitioners signed a Form 872 to consent to extend the time to assess tax for the taxable year 1979 until April 15, 1984. On March 29, 1984, respondent issued a notice of deficiency to petitioners for the taxable year 1979. Respondent contends that petitioners did not report a $1,700 gain from the sale of property in 1979. Moreover, respondent asserts that due to petitioner's negligence or intentional disregard of rules and regulations, petitioners should be subject to the five percent addition to tax under section 6653(a). Petitioner denies the sale of any property in 1979 and asserts that the basis in the Property was $5,090.

OPINION

Section 61(a)(3) provides that gross income includes "gains derived from dealings in property." Section 1001(a) states that

> the gain from the sale * * * of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 * * *

The amount realized from the sale of property is the sum of any money received plus the fair market value of the property received. Section 1001(b). The adjusted basis is the basis as determined under section 1012 and adjusted as provided in section 1016. Section 1011. Section 1012 states that the basis of property shall be its cost.

The first issue for determination is whether petitioner received unreported income of $1,700 in the taxable year 1979. Respondent asserts that during 1979 petitioners sold property with a basis of $300 for a sales price of $2,000. Petitioner's position is that (1) there was no sale of property in 1979 and, (2) if there was a sale, petitioner's basis in the property would be over $5,090.

Respondent's determination of the deficiency is presumptively correct. Welch v. Helvering, 290 U.S. 111, 115 (1933). In order to overcome this presumption, petitioner must offer evidence that shows the determination to be erroneous. Gersten v. Commissioner, 267 F.2d 195, 199 (9th Cir. 1959), affg. in part 28 T.C. 756 (1957). Petitioner bears the burden of proof. Rule 142(a). Turning to the facts before the Court, petitioner denies that he sold the Property to Lesuer.

Petitioner argues that Lesuer's $2,000 check dated June 18, 1979, which petitioner negotiated in 1979, represents a deposit for the purchase of the Property. Petitioner pursues this line of argument despite a civil judgment in a quiet title action that Lesuer received good title to the Property from petitioner by quit-claim deed for a purchase price of $2,000 in 1979, and a signed handwritten receipt to Lesuer that the $2,000 was "in full payment for property described as Lot 98 and Lots 29 and 30 Green Valley Ranch, Jefferson County Colorado."

We are not bound to accept petitioner's testimony at face if it is improbable, unreasonable or questionable. Baird v. Commissioner, 438 F.2d 490, 493 (3d Cir. 1970). Not only is petitioner's testimony at trial improbable, unreasonable or questionable, it is clearly contradicted by respondent's evidence, in particular the handwritten receipt and civil court judgment. As a result, we find that petitioner has not met his burden of proof and uphold respondent's determination that a sale of the Property for $2,000 with a $300 basis occurred in 1979.

Petitioner asserts that if there was a sale of the Property in 1979, petitioner's basis in the Property would be over $5,090. Again, in order to overcome the presumption that respondent's determination of a $300 basis is correct, petitioner bears the burden of proof and must offer evidence that shows the determination to be erroneous. Gersten v. Commissioner, supra at 199; Rule 142(a). As proof, petitioner points to the Report and

Return of the Sheriff of Jefferson County which contains the Execution of the Sheriff's Sale of the Property to petitioner for $5,090. The $5,090 amount consists of the following:

the judgment amount	$453.08
interest	72.50
court costs	4,283.60
additional costs	213.45
sheriff's costs	67.37

However, respondent asserts and petitioner's testimony corroborates that of the costs enumerated in the sheriff's report, petitioner only paid $228 to purchase the $453.08 judgment from Pay-Center, Inc. and the $67.37 amount of sheriff's costs to enforce the judgment. Petitioner did not pay the interest, the court costs[3] or additional costs.[4] Under section 1012, petitioner's cost for the Property was $228 for the assignment of the judgment from Pay-Center, Inc. Under section 1016, petitioner may increase his basis for legal recording fees such as sheriff's fees paid by petitioner in connection with the acquisition of the property.[5] As a result, we hold that petitioner's cost basis in the property is $300 as determined by respondent because petitioner has failed to sustain his burden of proof as to the validity of the $5,090 basis amount.

---

[3] Court costs included petitioner's $4,250 personal service fee. Petitioner presented no evidence as to what, if any, services he performed. Moreover, petitioner took none of the $4,250 into income for these services, and, as a general principle, cannot claim this amount as part of his basis in the property. Bryan v. Commissioner, 16 T.C. 972, 981 (1951).

[4] The additional costs included an abstract of title which was dated January 21, 1981, almost two years after the sheriff's sale.

[5] Vadner v. Commissioner, T.C. Memo. 1955-218.

Finally, we consider whether petitioner is liable for addition to tax under section 6653(a). This section provides for additions to tax if any part of the underpayment is due to negligence or an intentional disregard of the rules or regulations. Under section 6653(a), negligence is the lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Neely v. Commissioner, 85 T.C. 934, 947 (1985). The burden of proof is on petitioner to establish that he is not liable for the addition to tax. Bixby v. Commissioner, 58 T.C. 757, 791 (1972).

Petitioner has failed to introduce any evidence to carry his burden of proof. Moreover, what is particularly reprehensible in this case is that petitioner served as a revenue agent for the Internal Revenue Service during the taxable year in question and, as such, should be aware of his statutory duty to report income in the year of realization.

On the basis of this record, we hold that petitioners have failed to carry their burden of showing that a sale of property with a basis of $300 for a price of $2,000 did not take place in 1979 and that the resulting underpayment of tax was not due to negligence or intentional disregard of rules and regulations.

Accordingly, we sustain respondent's determinations of a statutory deficiency of $544.00 and an addition to tax under section 6653(a) of $27.00 for the taxable year 1979.

To reflect the foregoing,

Decision will be entered

for the respondent.

742-13 Ju 11.7/2 : 1986-39
COMPLETED
8
mf 210

ORIGINAL

T. C. Memo. 1986-393

UNITED STATES TAX COURT

DON C. DeSARGENT, Petitioner v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 21057-83. Filed August 25, 1986.

Don E. DeSargent, pro se.

Marqueritte Britton, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARR, Judge: Respondent determined a deficiency in petitioner's 1978 Federal income tax in the amount of $5,490.37 and an addition to tax under section 6651(a)[1] in the amount of $192.59. The issues for our consideration are whether petitioner properly claimed employee business expense deductions in the amount of $11,398.00 and whether he is liable for an addition to tax for filing his return late.

---

[1] All section references are to the Internal Revenue Code of 1954, as amended, and in effect during the year in issue and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and attached exhibits are incorporated herein, as are petitioner's exhibits 3, 4, and 5, admitted into evidence without objection by respondent after trial but before the record in this case was closed.

Petitioner resided in New York City when he filed his petition. His 1978 tax return, filed on October 15, 1980 with the Ogden, Utah Internal Revenue Service Center, used the married filing separate status. Petitioner timely submitted to the Ogden Service Center a Form 4868 Application for Extension of Time to File U.S. Individual Income Tax Return for the 1978 tax year. The application, dated April 11, 1979, was denied by the director of the Ogden Service Center on May 15, 1979, apparently without explanation.

On his 1978 income tax return petitioner deducted $11,398 as employee business expenses, consisting of $2,950 for transportation and $8,448 for meals and lodging. Respondent disallowed the entire amount for lack of substantiation, because petitioner was not away from home when the expenses were incurred, and because they are personal, not business expenses.

Petitioner is an elderly gentleman who impressed the Court as being sincere and truthful. He has spent most of his life serving his country in various capacities, both military and civilian. In the armed forces he was a chief pharmacist's mate. He is an engineer, and holds marine and air conditioning-refrigeration licenses.

Unfortunately, this case involves incidents that occurred eight years ago, and petitioner's memory was understandably hazy on details. Most documentation that would have provided additional substantiation has long since disappeared.

In 1975 petitioner left New York to look for engineering work in Alaska. He rented an apartment in Anchorage and temporarily took a nursing job working with Indians and Eskimos. In late 1976 or early 1977 petitioner began a permanent job as an engineer at an air force base in a remote mountain area.

Transportation to Anchorage was only by bush pilot or military transport. During the year in issue, free housing was provided at the base, but petitioner kept his apartment in Anchorage, which cost $200 per month.[2] Petitioner purchased his food at the base. Petitioner kept his apartment (1) because he was required to have a place where he could be reached when away from the base, (2) because he needed a place to keep his tools and personal things, and (3) as a place to spend free time.

---

[2] Although petitioner testified he paid about $225 monthly rent, he submitted Alaska rent receipts in the amount of $2,400. We therefore find he paid $200 per month rent.

Petitioner claimed a deduction for $2,950.00 in transportation fares. Petitioner submitted six airline tickets showing charges of $1,129.00 incurred traveling between Anchorage and Seattle, St. Paul, and New York. Petitioner testified that he also flew between the military base and Anchorage approximately three times a month, at a cost ranging from $200 to $500 round trip, depending on whether he used a bush pilot or military transport. No documents were offered to substantiate these amounts. Petitioner testified that at least three of these trips were required for surgery to his jaw and that additional trips were taken for vacation and weekend leave purposes. Petitioner flew to New York once for a back problem and a second time when his mother's apartment was ransacked.

Petitioner deducted $8,448 for meals and lodging. He submitted rent receipts from Alaska for 1978 in the amount of $2,400. In addition, petitioner paid rent on his mother's apartment in New York and deducted the cost of that apartment. Finally, petitioner substantiated $2,876 in 1978 moving expenses, incurred to store his mother's things when her apartment was vandalized.

Petitioner also testified he spent $350 for a coat, $65 to $100 for boots, and $200 to $250 for tools. Petitioner offered no substantiation of any of these amounts, however, and his recollection was vague.

OPINION

The determinations made by respondent in his notice of deficiency are presumed correct. Petitioner has the burden of proving those determinations are wrong. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Personal expenses are ordinarily not deductible. Sec. 262. Petitioner's travel to New York, rent on his mother's apartment, and the costs of storing her furniture are personal expenses, and are not deductible in any event.

Section 162(a)(2), however, allows a taxpayer to deduct certain traveling expenses paid or incurred while away from home in the pursuit of a trade or business if he can establish the traveling expenses were (1) reasonable and necessary, (2) incurred while "away from home," and (3) incurred in pursuit of a trade or business. Commissioner v. Flowers, 326 U.S. 465, 470 (1946); Foote v. Commissioner, 67 T.C. 1, 3 (1976). We hold that petitioner's claimed expenses were not incurred away from home, nor were they business expenses.

This Court has held that a taxpayer's "home" for the purpose of section 162(a)(2) is the vicinity of his principal place of business whenever his personal residence is not located in the same vicinity. Mitchell v. Commissioner, 74 T.C. 578, 581 (1980); Kroll v. Commissioner, 49 T.C. 557 (1968). There is, however, an exception to this rule when a taxpayer with a well-established tax home accepts temporary employment as opposed to indefinite employment elsewhere. In this context, temporary employment means the sort of employment in which termination within a short period of time could be logically expected and foreseen. Groover v. Commissioner, 714 F.2d 1103 (11th Cir. 1983), affg. a Memorandum Opinion of this Court; Albert v. Commissioner, 13 T.C. 129, 131 (1949). See also McCallister v. Commissioner, 70 T.C. 505, 509 (1978). On the other hand, whenever termination of employment cannot be expected or foreseen within a fixed or reasonably short period of time, the taxpayer's tax home shifts to such place of employment so that he cannot satisfy the "away from home" requirement. Verner v. Commissioner, 39 T.C. 749 (1963).

Petitioner contends his residence in 1978 was Anchorage. However, he acknowledges that his job at the air force base was permanent: "[I]t was permanent as long as you wanted it * * *." We so hold. Therefore, petitioner's "home" for the purpose of sec. 162(a)(2) was the air force base, and petitioner does not fall within the exception to the Mitchell rule.

We understand and sympathize with petitioner's desire to maintain an apartment in Anchorage, but we find that his reasons for doing so were predominantly personal. Although he testified that his employer required him to have a place where he could be reached, we think this could have been satisfied by leaving a telephone number where he could have been reached, such as a hotel or even a union hall. Petitioner did not present evidence he was required to maintain a permanent apartment to meet this requirement. Therefore, rent on the Anchorage apartment and transportation between the base and Anchorage are not deductible. The cost of petitioner's food, eaten on the base, is also a personal and nondeductible expense. Sec. 1.262-1(b), Income Tax Regs.

Petitioner's testimony regarding amounts spent for clothing and tools was general and unsubstantiated. Some of the items were for personal clothing. We hold he did not carry his burden of proving entitlement to more than $350.00, the amount claimed on his return and allowed by respondent.

Petitioner offered some evidence of medical expenses incurred in 1978. He estimated that a trip to New York for back pain caused by muscular strain cost approximately $700. However, petitioner provided no medical records or other verification, and expressed some uncertainty that this occurred in 1978. We therefore can give little weight to this testimony.

However, testimony concerning petitioner's jaw surgery was more detailed and credible. He produced a memorandum verifying absence from work for medical reasons in March 1978. Although the memorandum is not specific regarding the medical problem, it is some substantiation that petitioner was treated by a doctor in 1978, and lends support to his testimony. Petitioner was unable to specify how much of the dental surgeon's bill was covered by insurance. However, he testified he was required to make three round trip flights to Anchorage for the surgery and follow-up examinations. Based on petitioner's testimony that he usually paid between $200 and $500 per trip, we find that petitioner incurred $900 in medical expenses in 1978. See Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).

We turn now to the question of whether petitioner is liable for an addition to tax under section 6651(a) for filing his return late. Although petitioner sought an extension (which was, perhaps arbitrarily, denied) he did not file his 1978 return until October 15, 1980, 18 months after the return was due. To escape the addition to tax, petitioner must show his failure to timely file is due to reasonable cause and not due to willful neglect. See section 6651(a)(1). Petitioner's explanation is that he had to go to Anchorage to have his return prepared, as the military people on the base would not do it. He gave it to a tax return preparer in Anchorage, who sent it to the wrong address. Then he had to have it redone. He had to keep postponing the chore due to difficulty catching a flight out of the base. Finally, he decided to wait until he was back in the "lower 48" "to get a CPA or somebody equal" to do it.

While we sympathize with petitioner's frustration, we are not satisfied that he had to wait as long as he did to file. We therefore hold that petitioner has not shown his failure to timely file is due to reasonable cause. We sustain respondent's imposition of the addition to tax.

To reflect the medical expense allowed,

Decision will be entered

under Rule 155.

323 74273 Jul 11.7/21 1986-394

COMPLETED

16

mf 210

ORIGINAL

T. C. Memo. 1986-394

UNITED STATES TAX COURT

ETHEL H. BURKLE, ET AL.,[1] Petitioners v. COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket Nos. 10774-81, 11637-82, 12271-82, 16953-82. Filed August 25, 1986.

John E. Drew and John S. Mason, Jr., for the petitioner in docket Nos. 10774-81 and 16953-82.

Judith Burkle Reynolds, pro se in docket No. 11637-82.

David R. Schaefer and Stephen L. Saltzman for the petitioners in docket No. 12271-82.

---

[1] The following cases are consolidated herewith: Estate of Robert N. Burkle, Judith Burkle Reynolds, Co-Administratrix, docket No. 11637-82 and Estate of Robert N. Burkle, Deceased, Judith Burkle Reynolds and Margaret M. Burkle, Co-Administratrix and Margaret M. Burkle Surviving Wife, docket No. 12271-82.

Robert E. Marum and Powell W. Holly, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CLAPP, Judge: Respondent determined deficiencies in petitioner Ethel Burkle's Federal income tax in the amounts of $34,782.08 and $50,381.05 for the years 1977 and 1978 (docket Nos. 10774-81 and 16953-82, respectively). Respondent also determined a deficiency in the Federal income tax of the Estate of Robert N. Burkle, and Margaret M. Burkle, Surviving Spouse in the amount of $35,881.42 for the year 1977 (docket Nos. 11637-82 and 12271-82).

The issues for decision are (1) whether certain payments received by petitioner Ethel Burkle from her former husband's estate in 1977 and 1978 constitute alimony payments under section 71;[2] and (2) whether such payments are deductible by the estate under section 215 for the year 1977.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner Ethel Burkle (hereinafter referred to as Ethel) resided in North Haven, Connecticut at the time her petitions were filed. Robert N. Burkle, deceased (hereinafter referred to as Robert), was a resident of Connecticut on August 24, 1977, the date of his death and his estate was probated there. The co-administratrices, Margaret M. Burkle, who is also the surviving wife, and Judith Burkle Reynolds, daughter of the deceased, resided in Connecticut when the petitions in Docket Nos. 11637-82 and Docket No. 12271-82 were filed. Ethel timely filed individual income tax returns for the taxable years 1977 and 1978, using the cash basis method of accounting. A timely joint income tax return was filed for Robert, deceased, and Margaret M. Burkle, surviving spouse, for the taxable year 1977, using the cash basis method of accounting.

---

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue.

Robert and Ethel were married on April 29, 1935. Ethel initiated an action to dissolve the marriage on June 19, 1973. On January 14, 1975, a judgment dissolving the marriage was entered by the State of Connecticut Superior Court. Incorporated within the judgment was an agreement, dated January 2, 1975 executed by Robert and Ethel and negotiated by their separate counsel. The pertinent provisions of the agreement provide as follows:

> Whereas, on the 19th day of June, 1973, the Wife commenced an action for divorce or dissolution of said marriage seeking alimony, returnable to the Superior Court for New Haven County, and * * *
>
> Whereas, the parties desire to settle amicably and to determine as between themselves, and out of Court, the question of the right of the Wife to alimony, and the amount thereof, it is therefore AGREED:

* * *

2. The following agreements have been reached with respect to transfers by Husband to Wife as lump sum alimony absolutely and without condition.

(a) The Husband shall transfer to Wife his interest in premises located at 82 Hartley Street in North Haven, Connecticut. * * *

(b) The Husband shall forthwith pay Ten thousand ($10,000.) dollars in cash to the Wife.

(c) The Husband shall forthwith pay the sum of Three thousand, five hundred ($3,500.) dollars on account of attorney fees incurred by Wife.

3. The following agreements have been reached with respect to periodic payments by Husband to Wife from income of Husband which shall continue so long as Husband shall live and subject to termination in the event of death or remarriage of Wife:

(a) Effective October 1, 1974, Husband shall pay to Wife fifty (50%) percent of gross salary thereafter earned by him from Autac, Inc. and/or Wire, Inc. up to a salary of Thirty thousand ($30,000.) dollars. * * *

(b) Effective October 1, 1974, Husband shall pay to Wife thirty (30%) percent of net income in excess of Thirty thousand ($30,000.) dollars thereafter earned by him from Autac, Inc. and/or Wire, Inc. Net income, for the purpose of this subparagraph, shall mean salary earned by or dividends paid to Husband by Wire, Inc. or Autac, Inc. in excess of Thirty thousand ($30,000.00) dollars less that amount payable to the United States as taxes on all such excess payments, taking into consideration, however, the deduction Husband will have for alimony payments and all other proper deductions.

* * *

4. The following agreement has been reached with respect to control of corporations owned by Husband, Wire, Inc. and Autac, Inc. and with respect to undistributed earnings of either corporation.

(a) Husband shall have full control of both corporations and his decisions as to the necessity for accumulation of corporate funds or what he determines to be good business practice shall be final. * * * In

> the event of a bona fide sale of either corporation or in the event of the death of the Husband, the Wife shall receive further payment, as follows:
>
> (i) In the event of a sale and after payment of all corporate liabilities, Husband will receive first a payment equivalent to the net worth of the corporation sold as shown on the year-end statement for the Spring of 1974. From the remaining funds resulting from such sale Wife will receive thirty (30%) percent of the net increase in book value occurring during and after the fiscal year which began in the Spring of 1974. * * * It is the purpose of this paragraph to provide for payment of alimony from earnings retained hereafter on hand at time of sale.
>
> (ii) In the event of the death of the Husband the Administrator or Executor of his estate may elect to sell said corporation and in the event of a bona fide sale the provisions of paragraph 4(a)(i) shall apply and Wife shall be deemed to be an interested party in any probate hearing concerning the bona fides of sale.
>
> (iii) In the event that Husband should die and his Administrator or Executor should elect not to sell his interest in Autac, Inc. or Wire, Inc., then and in that event, Wife shall be paid based on paragraph 4(a)(i) as if there had been a sale permitting full payment of the thirty (30%) percent net increase in book value, said payment to be made within twelve (12) months of the appointment of the Executor or Administrator.
>
> * * *
>
> (c) It is specifically understood and agreed that in the event of the death of the Wife or the remarriage of the Wife prior to the sale of the business or prior to the death of Husband, then the provisions of this Agreement with respect to payment of thirty (30%) percent of net equity in the event of sale of corporation or its stock or death of Husband shall expire and terminate.

Paragraph five of the agreement contains provisions for determining alternate alimony payments in the event that Robert was no longer employed or in control of the two corporations, Autac, Inc. and Wire, Inc. Paragraph six provides that Robert would pay to Ethel as alimony 15 percent of that portion of rent, received by Robert from the two corporations, which he used for his personal benefit. This obligation ceased in the event of either party's death or Ethel's remarriage.

Paragraph seven provides as follows:

> Husband shall deliver a note in the amount of Fifty Thousand ($50,000.00) Dollars and said note shall be secured by a mortgage on the business real estate located in North Branford Connecticut. No interest shall be paid on said note and said note shall expire and terminate in the event of the remarriage of Wife or death of Wife before Husband. Said note shall be payable in the event of sale of such real estate or in the event of the death of Husband. The said note shall bear the description of the terminable interest.

The promissory note itself stated that it would expire in the event of Ethel's remarriage but, contrary to the agreement, did not contain the proviso with respect to the wife's death before the husband.

Paragraph 12 of the agreement states that in consideration of the undertaking of the husband under the agreement, the wife would relinquish all claims against the husband for "other forms of alimony, support and maintenance."

Prior to the entry of judgment of the divorce, Robert owned all the outstanding stock of Autac, Inc. and Wire, Inc., two Subchapter S Corporations. In the financial affidavit, dated September 13, 1974, filed by Ethel in the divorce action, she did not list as an asset any interest in Autac, Inc. or Wire, Inc.

Ethel received monthly payments from Robert from January 1, 1977, through August 1, 1977, totalling $14,940. Robert died on August 24, 1977. By letter dated October 5, 1977, Ethel's attorney presented a claim to the estate on behalf of Ethel in the tentative amount of $175,000 consisting of (a) the $50,000 promissory note by Robert to Ethel referred to in paragraph 7 of the above agreement and (b) $125,000 based on paragraphs three and four of the agreement. The estate issued two checks to Ethel, dated December 21, 1977 and December 27, 1977, in the amounts of $40,000 and $25,000. The letters from the estate transferring the checks and the checks themselves note that they are payment on account of the claim made by Ethel on October 5, 1977 regarding section (b) relative to alimony due. A check, dated October 31, 1978, in the amount of $96,000 was paid by the estate to Ethel, representing payment in full of Ethel's claim. The amount of $96,000 was arrived at as a compromise between the amount presented by Ethel and the amount computed by the estate. Ethel's attorney had computed the amount due as follows:

Ethel's 30% share of salary over $30,000 and increase in net worth of corporations		$121,766.94
Rent		5,250.00
Note		50,000.00
		$177,016.94
Less Payments made		
1975	$ 3,000	
1976	13,000	
1977	64,940	80,940.00
		$ 96,076.94

The estate computed the amount due as follows:

50% of salary up to $30,000	$ 15,000.00
30% of excess salary over $30,000	20,844.97
Rent	5,250.00
Increase in book value	82,628.37
Alimony due	$123,723.34
Second mortgage Note	50,000.00
Total	$173,723.34
Less Payments to date	
$14,940	
$65,000	79,940.00
Balance	$ 93,783.34

Ethel reported on her 1977 tax return the monthly payments of $14,940 as alimony received and these payments are not in dispute. She did not include in income the amounts received in 1977 totalling $65,000 or the $96,000 received in 1978 but noted on her returns for the years 1977 and 1978, that the payments were received as a nontaxable property settlement and a nontaxable distribution, respectively. The 1977 joint income tax return of Margaret Burkle and Robert claimed a deduction for alimony for the $65,000 payment made in 1977. In the notices of deficiency issued to Ethel for the years 1977 and 1978, respondent determined that the payments in question received by Ethel constituted alimony income. Respondent issued a notice of deficiency of income tax for the year 1977 to the Estate of Robert Burkle, Judith Burkle Reynolds and Margaret Burkle, Co-Administratrix (sic) and Margaret Burkle, Surviving Wife, stating that the $65,000 payments were not includable in Ethel's income and denying the alimony deduction under section 215. Separate petitions were filed by Judith Reynolds and Margaret Burkle.

OPINION

Ethel contends that the amounts she received from the estate do not constitute taxable income under section 71 but rather represent lump-sum payments in recognition of her contributions to her husband's business. Ethel also contends that the amounts paid by the estate in 1977 and 1978 are not deductible under section 215. Therefore, the inclusion in her income as taxable alimony, she argues, would constitute a distortion of income. Petitioners Estate of Robert Burkle and Margaret Burkle, Surviving Wife (hereinafter sometimes referred to as petitioners in the plural) contend that the payments made in 1977 are periodic payments which constitute taxable income to Ethel under section 71 and are deductible by petitioners under section 215. The deductibility of the payment of $96,000 in 1978 is not at issue in these cases. Respondent on initial brief stated that the notices of deficiency took inconsistent positions with respect to the year 1977 and, without abandoning this stakeholder position, argued that the amounts received by Ethel in 1977 and 1978 were includable in income under section 71 and were deductible on the joint return of petitioners with respect to the payments made in 1977 under section 215. However, on reply brief, respondent, while still arguing that the payments are income to Ethel, agrees with Ethel that they are not deductible by petitioners under section 215.

The initial issue for decision is whether the payments received by Ethel constitute taxable income under section 71. Section 71(a)(1) as in effect during the years at issue provides:

> If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

Section 71(c)(1) provides:

> (1) General Rule.--For purposes of subsection (a), installment payments discharging a part of an obligation the principal sum of which is, either in terms of money or property, specified in the decree, instrument, or agreement shall not be treated as periodic payments.

The primary issue here is whether the payments made by the estate constitute periodic payments or payments of a principal sum. A principal sum specified in the decree or agreement is one that is readily ascertainable in amount and is not contingent on the happening of certain events. Baker v. Commissioner, 205 F.2d 369 (2d Cir. 1953), affg. in part and revg. in part 17 T.C. 1610 (1952); Prewett v. Commissioner, 221 F.2d 250 (8th Cir. 1955), revg. 22 T.C. 270 (1954). Section 1.71-1(d) of the Income Tax Regulations provides that payments are not installment payments of a principal sum even though the sum is specified in money or property (and therefore are considered periodic payments) if the payments are subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse and such payments are in the nature of alimony or an allowance for support. The validity of the regulations was upheld by this Court in Kent v. Commissioner, 61 T.C. 133 (1973).

Initially, we note that, while under Connecticut law the obligation of the husband to support his wife normally ceases upon his death, when a separation agreement provides that the husband's estate will continue to make support payments, the estate is obligated to make the payments. McDonnell v. McDonnell, 166 Conn. 146, 348 A.2d 575 (1974).

In the instant case, we have different provisions in the agreement imposing different payment obligations, therefore, we will examine each provision separately. Bernstein v. Commissioner, 622 F.2d 442 (9th Cir. 1980), affg. a Memorandum Opinion of this Court; Bartsch v. Commissioner, 18 T.C. 65 (1952) affd. 203 F.2d 715 (2d Cir. 1953). Paragraphs 3(a) and (b) clearly call for periodic payments based on a percentage of Robert's salary and dividends. Paragraph six regarding rent that Robert would receive from the two corporations does not set forth an ascertainable sum but is based on a percentage of that portion of rent which Robert uses for his personal benefit.

Ethel argues that upon Robert's death, the periodic payments called for in paragraphs three and six ceased and Ethel then became entitled to a lump sum payment in accordance with paragraphs four and seven of the agreement. While it is true under the terms of the agreement that the payments under paragraph three and paragraph six terminated on Robert's death, both Ethel in presenting her claim and the estate in its computations included amounts due under these provisions. However, the record is not clear what portion of the payments was allocable to these provisions. In any event, it is clear and we do not understand Ethel to argue otherwise that periodic payments are called for under paragraphs three and six. Because of our determinations below, it is not necessary to decide what amount is allocable to these payments.

Paragraph four also does not set forth a definite sum but is based upon a percentage of net increase in value of the two corporations to be determined upon their sale or Robert's death. Clearly no ascertainable principal sum is specified in the agreement.[3] Paragraph four intended to provide for alimony from earnings retained after the date of agreement. This provision was intended to protect Ethel from Robert's decisions to retain earnings in the company rather than pay them out to himself. In the latter case, they would be subject to the percentage alimony provisions in paragraph three. In the former case, without paragraph four, Ethel would never receive her share of the corporate earnings. This adds further weight to the argument that the payments at issue herein were periodic payments. In addition, no amount needed to be paid if Ethel had remarried or predeceased her former husband.

---

[3] See Swendseen v. Commissioner, T.C. Memo. 1978-501.

The obligation to pay under paragraph seven does specify a sum of money but it is also clearly contingent upon Ethel's surviving her husband and not remarrying. As such, it lacks the "fairly definite character" needed to constitute a principal sum. Baker v. Commissioner, supra.

While it is true, as Ethel argues, that at the time the payments were made, the amounts were ascertainable and subject to no contingencies, the statute is clear that the principal sum must be specified in the agreement.

The contingent nature of the payments is indicative of a support obligation rather than a property settlement. McCombs v. Commissioner, 397 F.2d 4, 7 (10th Cir. 1968), affg. a Memorandum Opinion of this Court; Beard v. Commissioner, 77 T.C. 1275, 1285 (1981). The agreement itself designates the amounts as alimony rather than a property division. While the labels contained in an agreement are not controlling, they are entitled to some probative value where the agreement was subject to negotiations with each party represented by counsel. Schottenstein v. Commissioner, 75 T.C. 451, 457 (1980). Ethel claims that the amounts she received were not for support but were made in recognition of the contributions she made to her husband's business citing section 1.71-1(a)(4) of the Income Tax Regulations which states:

> section 71(a) does not apply to that part of any periodic payment which is attributable to the repayment by the husband of, for example, a bona fide loan previously made to him by the wife, the satisfaction of which is specified in the decree, instrument, or agreement as a part of the general settlement between the husband and wife. * * *

Ethel testified that in the early 1960's she transferred some stock worth between $30,000 and $50,000 and in 1966 she transferred money she received from her father's estate, approximately $30,000, to Robert. The transfers were made a considerable number of years before the separation agreement was drawn up. There is no evidence as to how this money was used or if it was used solely for the benefit of her husband's business. The financial affidavit submitted by Ethel during the divorce proceedings shows no ownership interest of Ethel in the business. The amounts to be paid under paragraphs three, four and six were based on Robert's future income rather than based on any past contributions made by Ethel. Finally, the contingent nature of the payments provided for in the agreement, including paragraph seven, belies Ethel's argument. Had she remarried she would receive nothing under any of the relevant provisions of the agreement. Based on the foregoing, we conclude that the payments received by Ethel are taxable under section 71.

The next issue for decision is whether petitioners, the estate and Margaret, are entitled to a deduction under section 215 on the joint Form 1040 return. Section 215(a) provides:

> In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. * * * [Emphasis added.]

Section 1.215-1(b) of the Income Tax Regulations provides as follows:

> The deduction under section 215 is allowed only to the obligor spouse. It is not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse. * * *

Under section 215 and the applicable regulations, only the obligor-spouse is entitled to an alimony deduction. Estate of Jarboe v. Commmissioner, 39 T.C. 690, 696 (1963).[4]

The fact that a joint return by the estate and Margaret was filed for 1977 does not change the result. Section 6013(a)(2) provides as follows:

> no joint return shall be made if the husband and wife have different taxable years; except that if such taxable years begin on the same day and end on different days because of the death of either or both, then the joint return may be made with respect to the taxable year of each. * * *

While Margaret's taxable year was for the full calendar year of 1977, the taxable year for Robert ended on August 24, 1977, the date of his death. The amounts at issue were not paid during his taxable year, therefore, they are not deductible under section 215. Petitioners cite section 1.6013-3 of the Income Tax

---

[4] Arnall v. Commissioner, T.C. Memo. 1983-232.

BEST COPY AVAILABLE

Regulations which states that where the husband and wife have different taxable years because of the death of either spouse, the joint return shall be treated as if the taxable years of both ended on the date of the closing of the surviving spouse's taxable year. However, petitioners omitted the rest of the regulation which makes it clear that this statement is for purposes of particular Code provisions, none of which is applicable here.

The disallowance of the deduction under section 215[5] does not mean, however, that Ethel does not include the payments in her income. Periodic payments by the estate are includable in the wife's gross income regardless of the source of payments. Girard Trust Co. v. Commissioner, 16 T.C. 1398, 1401 (1951), affd. 194 F.2d 708 (3d Cir. 1952); section 1.71-1(c)(2) of the Income Tax Regulations.

Based on the foregoing,

Decisions will be entered

for the respondent.

---

[5] The estate may be entitled to a distribution deduction for the payments under the income tax rules applicable to estates in Subchapter J and it may also be entitled to a deduction on the estate tax return. Estate of Laughlin v. Commissioner, 167 F.2d 828 (9th Cir. 1948) revg. 8 T.C. 33 (1947); Izrastzoff v. Commissioner, 15 T.C. 573 (1950), affd. 193 F.2d 625 (2d Cir. 1952). However, neither the fiduciary income tax return nor estate tax return are at issue in this case.

323 742-B Ju 11.7/2:1986-395

COMPLETED

MF 21Φ 23

ORIGINAL

T. C. Memo. 1986-395

UNITED STATES TAX COURT

JAMES W. McLEOD, Petitioner, v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 5275-85, 40182-85. Filed August 25, 1986.

Joseph H. Blackwell, for the petitioner.[1]

Frank R. DeSantis (trial only) and Craig S. Morford, for the respondent.

MEMORANDUM OPINION

WILLIAMS, Judge: In these consolidated cases, the Commissioner determined deficiencies in petitioner's Federal income tax and additions to tax pursuant to section 6653(b)[2] for the taxable years 1974, 1975, 1976 and 1977 as follows:

---

[1] Mr. Blackwell represented petitioner at trial. The petitioner filed no briefs in this case.

[2] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, unless otherwise indicated.

Docket No.	Year	Deficiency	Additions to Tax
5275-85	1974	$ 4,480.66	$ 2,240.33
	1975	5,649.82	2,824.91
	1976	41,350.54	20,675.27
40182-85	1977	16,269.57	8,134.78

This Court must decide: (1) whether petitioner failed to report income for the taxable years 1974, 1975, 1976 and 1977; and if so, (2) whether any part of the underpayment of tax for each of the taxable years 1974, 1975, 1976 and 1977 was due to fraud with intent to avoid Federal income tax within the meaning of section 6653(b).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Petitioner, James W. McLeod, resided at Cleveland Heights, Ohio at the time the petitions in these cases were filed.

Petitioner was born on June 21, 1935 in Alabama. Petitioner's mother, Dessie Washington (Dessie), and brother, James L. McLeod (J.L.), currently reside in Ozark, Alabama. Petitioner moved to Cleveland, Ohio in 1951 and was employed by the National Casting Company as a laborer until 1957, at which time he was drafted into the Army. Petitioner was honorably discharged in 1959, and he returned to his former job at the National Casting Company in Cleveland. Petitioner was periodically laid off by the National Casting Company, during which periods he was generally employed by the Empire Plow Company.

Petitioner claims to have saved between $7,000.00 and $8,000.00 in cash from his earnings while in the armed services. These savings were not deposited in a bank. In 1960 petitioner filed for bankruptcy to protect himself from creditors holding notes petitioner had cosigned prior to entering the Army. Petitioner did not report the $7,000.00 or $8,000.00 in cash savings either to the attorney preparing his bankruptcy petition or to the Federal court in which he filed his bankruptcy petition.

From 1964 through and including 1977 petitioner was employed by the Fisher Body Division of the General Motors Corporation (Fisher Body), in Cleveland. Petitioner's yearly earnings from his employment at Fisher Body were as follows:

Year	Gross Earnings	Taxes and Other Deductions	Credit Union Deductions
1964	$ 1,722.53	$ 216.26	-0-
1965	6,568.87	896.84	-0-
1966	5,535.79	1,023.35	-0-
1967	5,798.40	1,247.41	1,250.00
1968	8,216.35	1,938.81	2,350.00
1969	5,873.25	1,666.75	1,850.00
1970	5,507.49	1,381.01	1,550.00
1971	11,210.70	2,511.56	2,400.00
1972	10,300.46	2,587.11	2,350.00
1973	12,058.52	3,282.54	2,450.00
1974	2,486.41	528.94	150.00
1975	5,424.14	1,827.78	1,400.00
1976	8,028.01	2,113.86	1,750.00
1977	12,633.67	*	*
Totals:	$101,364.59	$21,222.22	$17,500.00

*Not in record.

Commencing in 1955 petitioner served as the custodian for a building owned by Emil Bruh and Stanley Bruh, father and son, located at 1696 East 79th Street in Cleveland. For his services petitioner was provided a rent-free first-floor apartment in the building. The building contained eight apartments and four single rooms, none of which was vacant for more than one week at a time. The single rooms were rented for $44.00 per month. Petitioner's basic duties as custodian were to collect rents and to maintain the building. Petitioner forwarded to the building's owners a check for the rent collected.

Petitioner was indicted on March 31, 1981 and charged with violating section 7201[3] for the taxable years 1974, 1975, 1976 and 1977. Petitioner pleaded guilty to Count II of the indictment pursuant to a plea agreement under which the remaining Counts against petitioner were dismissed. Count II charged petitioner with violating section 7201 for the taxable year 1975.

During the years before the Court, petitioner acquired certain assets in the name of nominees. Petitioner purchased a 1976 Chevrolet van in October of 1976. The van was purchased in the names of Charles King and Van Sales. These individuals subsequently transferred their interest in the vehicle to petitioner, for which they received no consideration. Petitioner himself paid the entire purchase price, $9,522.00, in cash. In 1977 petitioner also acquired real estate at 1655 East 79th Street for $9,000.00 cash in the name of Charles King, though Charles King did not contribute any of his own funds to the acquisition of the property. On April 20, 1977, petitioner purchased a 1977 Thunderbird for $7,030.41. Petitioner paid the full amount for the automobile in cash, which was acquired in the name of Linda Shipman, petitioner's daughter.

---

[3] Section 7201. ATTEMPT TO EVADE OR DEFEAT TAX.

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000 or imprisoned not more than 5 years, or both, together with the costs of prosecution.

Petitioner also gave substantial gifts to his relatives. In 1974 petitioner bought a 1974 LTD, paying cash, which he gave to his mother. In 1975 petitioner gave his mother $11,000.00 cash, $3,950.00 of which was used for a down payment on a new home. In 1976 petitioner gave his mother $6,300.00 to build a swimming pool at her new home and $15,000 to purchase a dry cleaners. In 1977 petitioner purchased two 1977 Ford LTD's for a total of $12,425.80 paying cash. One car was purchased for his mother, Dessie Washington, and the other for his stepfather, Ben Keys. Petitioner's brother, J.L., delivered the cars to Alabama a short time after they were purchased by petitioner.

On April 1, 1976 petitioner purchased a house at 3665 Brinkmore Road in Cleveland. The cost of the house was $48,000.00, for which petitioner paid $30,000.00 in cash and financed the remaining $18,000.00. In connection with this transaction a Form 4789, Currency Transaction Report, was filed with respondent on April 8, 1976, noting a deposit to escrow account of $29,455.00.

Throughout the years at issue in these cases petitioner maintained no books or records. Petitioner's income tax returns for the years 1970 through 1977 report gross income in the following amounts:

Taxable Year	Gross Income
1970	$ 5,947.00
1971	11,211.00
1972	10,300.00
1973	***
1974	2,504.10
1975	5,424.14
1976	8,116.00
1977	14,626.44

***Return not in record.

Respondent determined that petitioner had assets and liabilities, for the years indicated, in the following amounts:

Assets	12/31/73	12/31/74	12/31/75	12/31/76	12/31/77
Cash in bank	$ 2,025.15	$ 8,737.29	$ 5,399.47	$ 9,350.56	$ 10,499.71
Receivable--refund due from overpayment on Cadillac	-0-	-0-	4,000.00	-0-	-0-
Receivable--Frieda McLeod	-0-	-0-	-0-	45.00	45.00
Real Estate—1655 E. 79th St.	-0-	-0-	-0-	-0-	9,000.00
Real Estate—3665 Brinkmore	-0-	-0-	-0-	48,455.00	48,455.00
Carpeting and appliances	-0-	-0-	-0-	8,661.82	13,093.83
Furniture and Furnishings	-0-	-0-	-0-	22,728.65	29,113.08
Prepaid Interest	3,913.96	3,304.00	2,694.04	-0-	-0-
Automobiles	21,862.63	20,679.00	22,463.50	15,034.00	15,034.00
Total assets	$27,801.74	$32,720.29	$34,557.01	$104,275.03	$125,240.62
Liabilities:					
Accum. Deprec.—1655 E. 79th St. Residence	$ -0-	$ -0-	$ -0-	$ -0-	$ 600.00
Notes and mortgage payable: Local 45 Credit Union	2,985.39	1,750.61	4,180.98	-0-	-0-
Cleveland Federal	-0-	-0-	-0-	17,936.28	17,758.25
Central National Bank	1,424.34	35.85	35.85	35.85	35.85
Society National Bank	14,626.15	12,346.75	10,067.35	-0-	-0-
Total liabilities	$19,035.88	$14,133.21	$14,284.18	$17,972.13	$18,394.10
Net worth	$ 8,765.86	$18,587.08	$20,272.83	$86,302.90	$106,846.52

Respondent determined that petitioner owned the following automobiles during the years indicated:

Automobiles:	1973	1974	1975	1976	1977
1974 Cadillac	$ 7,280.00	$ 7,280.00	$ -0-	$ -0-	-0-
1974 Honda	-0-	299.00	-0-	-0-	-0-
1975 Honda	-0-	-0-	598.50	598.50	598.50
1976 Chevrolet Van	-0-	-0-	-0-	9,027.00	9,027.00
1972 Ford Pinto	2,582.63	-0-	-0-	-0-	-0-
1976 Cadillac	-0-	-0-	8,765.00	-0-	-0-
1973 Champion Motor Home	12,000.00	12,000.00	12,000.00	-0-	-0-
1972 Corvette	-0-	-0-	-0-	5,408.50	5,408.50
1971 Pontiac Station Wagon	-0-	1,100.00	1,100.00	-0	-0-
Automobiles	$21,862.63	$20,679.00	$22,463.50	$15,034.00	$15,034.00

Respondent'determined that petitioner expended the following for personal living expenses during the years indicated:

Personal living expenses	1974	1975	1976	1977
Recreation, entertainment, vacations	$ 114.00	$ 135.00	$ 100.00	$ -0-
Bank service charge	12.85	16.85	14.80	-0-
Bank Americard payments	2,163.30	-0-	-0-	-0-
Utilities	123.62	405.23	282.21	1,200.85
May Company insurance	254.44	-0-	-0-	-0-
Miscellaneous	1,219.19	594.79	699.51	-0-
Auto insurance and dues	227.00	487.00	531.73	885.46
Motor home insurance	174.75	165.25	-0-	-0-
Auto repairs	210.00	356.94	390.86	-0-
FICA	65.79	313.74	469.64	739.07
Federal Income Taxes	369.65	739.33	1,157.00	2,029.91
Child support	720.00	720.00	960.00	1,200.00
One-half cost of Sea Nymph	182.03	-0-	-0-	-0-
One-half cost of boat motor and trailer	145.98	-0-	-0-	-0-
Interest - 45 Credit Union	290.83	69.46	435.49	-0-
Interest - Society	609.96	609.96	1,078.11	-0-
Sales tax - 1974 Honda	13.46	-0-	-0-	-0-
Sales tax - 1971 Pontiac	49.50	-0-	-0-	-0-
Dentist Fee	52.00	-0-	156.00	-0-
City and state taxes	25.51	100.63	161.98	291.22
Union Dues	32.99	133.06	140.24	169.16
Gasoline tax	103.00	116.00	116.00	-0-
Gifts and allowances	-0-	11,171.00	22,410.00	885.00
May Company purchases	-0-	66.88	-0-	-0-
Sales tax - 1975 Honda	-0-	26.50	-0-	-0-
Sales tax - 1976 Cadillac	-0-	525.25	-0-	-0-
Tax return preparation	-0-	5.00	5.00	-0-
Contributions	-0-	5.00	-0-	-0-
Home insurance	-0-	-0-	151.00	162.00
Gas installation	-0-	-0-	182.40	-0-
Television antenna	-0-	-0-	205.62	-0-
Cash payments to ex-wife	-0-	-0-	10,000.00	-0-
Attorneys fees	-0-	-0-	650.00	500.00
Mortgage interest	-0-	-0-	691.11	1,472.36
Real estate taxes	-0-	-0-	565.99	1,139.70
Sales tax - 1976 Chevy Van	-0-	-0-	495.00	-0-
Sales tax - 1972 Corvette	-0-	-0-	297.00	-0-
Vacuum cleaner	-0-	-0-	-0-	379.27
Airline ticket	-0-	-0-	-0-	340.00
Home repairs	-0-	-0-	-0-	774.85
Total Personal living expenses	$7,159.85	$16,762.87	$42,346.69	$12,168.85

Respondent determined that petitioner made the following gifts during the years indicated:

Gifts and allowances:	1975	1976	1977
Cash gifts to JoAnn Baker	$ 171.00	$ 660.00	$ -0-
Cash gifts to Nathaniel Daniel	-0-	300.00	-0-
Cash gift to John McLeod	-0-	150.00	-0-
Cash gifts to and asset acquisitions for Dessie Washington:			
5/13/75, checking account deposit	5,000.00	-0-	-0-
5/13/75, savings account deposit	5,000.00	-0-	-0-
6/28/75, checking account deposit	1,000.00	-0-	-0-
7/30/76, savings account deposit	-0-	5,000.00	-0-
Swimming pool	-0-	6,300.00	-0-
Down payment on dry cleaners	-0-	10,000.00	-0-
Cash gifts to Carol Harmon	-0-	-0-	885.00
Total Gifts and allowances:	$11,171.00	$22,410.00	$885.00

BEST COPY AVAILABLE

Respondent determined the following adjustments in petitioner's income for the years indicated:

Adjustments:	1974	1975	1976	1977
Sick Pay	$(3,456.00)	$ (704.00)	$ -0-	$ (792.00)
Gift of 1974 LTD to Dessie	4,033.35	-0-	-0-	-0-
Loss on trade-in of Pinto	1,249.28	-0-	-0-	-0-
Income tax refunds	(126.97)	(308.65)	(255.33)	(150.00)
One-half payments made to petitioner on motor home	(1,139.76)	(1,139.76)	(189.96)	-0-
Gift of 1974 Cadillac to daughter	-0-	7,280.00	-0-	-0-
Tax rebate	-0-	(61.00)	-0-	-0-
Loss on 1974 Honda	-0-	124.00	-0-	-0-
Furniture refunds	-0-	-0-	(142.20)	-0-
Loss on sale of 1976 Cadillac	-0-	-0-	765.00	-0-
Loss on sale of motor home	-0-	-0-	3,000.00	-0-
Loss on sale of 1971 Pontiac	-0-	-0-	700.00	-0-
Purchase of 1977 Thunderbird	-0-	-0-	-0-	7,030.91
Purchase of 1977 Ford LTD for Dessie	-0-	-0-	-0-	6,650.35
Purchase of 1977 Ford LTD for Ben Keys, Jr.	-0-	-0-	-0-	5,775.35
Total Adjustments	$ 559.00	$ 5,190.59	$3,877.51	$18,514.61

The understatement of petitioner's income alleged by respondent was computed in the following manner:

COMPUTATION OF UNDERSTATEMENT

	1973	1974	1975	1976	1977
Net worth	$8,765.86	$18,587.08	$20,272.83	$ 86,302.90	$106,846.52
Net worth at beginning of year		8,756.86	18,587.08	20,272.83	86,302.90
Increase in net worth		9,821.22	1,685.75	66,030.07	20,543.62
Adjustments		559.90	5,190.59	3,877.51	18,514.61
Personal living expenses (including gifts and allowances)		7,159.85	16,762.87	42,346.69	12,168.85
Adjusted gross income as corrected		17,540.97	23,639.21	112,254.27	51,227.08
Adjusted gross income as reported		2,486.41	5,424.14	8,116.00	13,351.24
Understatement of adjusted gross income		$15,054.56	$18,215.07	$104,138.27	$37,875.84

OPINION

Petitioner contests respondent's determination that he understated his income for each year, 1974 through 1977, on two grounds. First, petitioner contends that he saved during prior years a total of $68,000.00 in cash, which he kept in a safe in the basement of his apartment at 1696 East 79th Street. He states that these cash savings were used to finance the purchase of his house at 3665 Brinkmore Road, the purchase of furniture and appliances for the house and the acquisition of other assets. Second, petitioner denies contributing any money toward the purchase of those assets held in others' names that were attributed to him by respondent. These include cash gifts to his mother in Alabama used to purchase a house, swimming pool and dry cleaners; gifts of automobiles to his mother and stepfather; and, assets purchased in the name of nominees. Instead, petitioner alleges the purchases were made by other parties, who each possessed cash hoards of their own.

Respondent contends that petitioner's "cash hoard" and the cash hoards of his relatives did not exist and, instead, that petitioner earned substantial amounts of income through the sale of marijuana. Respondent argues that petitioner attempted to conceal his acquisition of certain assets by placing such assets in the name of nominees, and attempted to impede respondent's investigation of petitioner by giving false statements to respondent's agents.

Respondent calculated petitioner's income by the net worth method of reconstructing income. The net worth method is used to reconstruct a taxpayer's income where, as here, the taxpayer fails to keep any books or records. Holland v. United States, 348 U.S. 121 (1954). The net worth method measures income by calculating the difference between the taxpayer's net worth at the opening and the closing of a given taxable year. Therefore, an essential element of this method is the opening net worth of the taxpayer.[4] Holland v. United States, supra. Respondent is required to investigate leads provided by taxpayer reasonably susceptible of being checked, which would establish likely sources of nontaxable income. Holland v. United States, supra; Friedman v. Commissioner, 421 F.2d 658 (6th Cir. 1970), affg. per curiam a Memorandum Opinion of this Court. Petitioner, however, bears the burden of proving that respondent's determination of petitioner's income is incorrect. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933).

Respondent has properly applied the net worth method of reconstructing petitioner's income in these cases. Petitioner kept no books or records from which his income could be accurately determined. Respondent has documented fully all assets, liabilities and expenditures of petitioner which were used in respondent's determination. Respondent's agent pursued all leads provided by petitioner with respect to petitioner's claim that he had significant sources of nontaxable income, by interviewing petitioner's mother, brother, daughter, ex-wife, various personal friends of petitioner and salesmen with whom petitioner transacted business in acquiring assets that he placed in the names of nominees or that were given to relatives. We find respondent's calculations, set forth in the Findings of Fact, reflect accurately the assets, liabilities and expenditures of petitioner during the years at issue in these cases.

---

[4] The net worth method, as noted, measures income by calculating the difference between the opening and closing net worth of the taxpayer (the excess of the taxpayer's adjusted basis in his assets over his liabilities) for a given taxable year. The increase (or decrease) in net worth is adjusted by adding nondeductible expenditures--e.g., personal living expenses, gifts and allowances--and subtracting nontaxable income items received--e.g., gifts, loans and cash savings. The result represents the income (or loss) attributed to the taxpayer for that year.

We find that petitioner's claims that he (1) had a cash hoard of $68,000.00 stored in a safe in the basement of 1696 East 79th Street and (2) owned no interest in the various assets that we find were purchased in the name of certain nominees to be wholly without merit.

Petitioner contends that he had accumulated savings of $68,000.00 from 1958 through 1976 by saving $50.00 per week for approximately 13 of the 18 years and $100.00 per week for the remaining five years. His principal sources of income were the National Casting Company and Fisher Body. Petitioner claims he earned supplemental income during these years by painting apartments and by renting vacant rooms at 1696 East 79th Street, where he was a custodian, to prostitutes. Two witnesses testified to support petitioner's claim of earning supplemental income, both of whom knew petitioner only during the early to mid-1960's. Other than his uncorroborated testimony, which we believe lacked candor, the record does not support petitioner's contention that he ever earned any significant supplemental income from painting apartments or any income from renting rooms to prostitutes. We believe that petitioner did earn supplemental income from painting apartments, but not enough to support a finding that he had a cash hoard in any amount. We conclude that petitioner had no cash savings at the beginning of 1974 other than the amount determined by respondent as set forth in the Findings of Fact.

Petitioner's testimony about his alleged cash hoard is fraught with inconsistency. For example, petitioner alleges that in 1975 he was saving $100.00 per week which he was able to do because he could live rent-free in the building in which he was custodian. His net earnings from his employment at Fisher Body in 1975, however, were only $4,686.73. Further, petitioner testified that he would have reported any other income on his Federal income tax return. The only source of income reported on his 1975 return was Fisher Body. Therefore, we conclude petitioner had no supplemental sources of income in 1975, and that petitioner did not accumulate any cash savings from reported income that year.

Similarly, we note that petitioner's returns for the years 1970 through 1974 and 1976, 1977 report no more than minimal amounts of supplemental income (strike benefits, interest, dividends or rent). We find that petitioner did not accumulate any cash savings from reported income during any of those years.

Petitioner claims that he kept his cash hoard in a heavy metal combination safe, which he stored in a coal bin in the basement of 1696 East 79th Street. Again, only petitioner's own uncorroborated testimony supports a finding that the cash or the safe existed. Petitioner testified that the safe remained in the coal bin of the basement of 1696 East 79th after petitioner moved to the house on Brinkmore Road in 1976, despite the fact that petitioner estimated that he left $20,000.00 in the safe. It is inconceivable that petitioner, who claims to have saved $100.00 per week, would leave $20,000.00 in the basement of a building in what petitioner himself described as a "rough area" after moving to a different part of town. Further, the building was condemned by the city in 1977 and later demolished (and with it any safe).

As noted, petitioner testified that approximately $20,000.00 of his $68,000.00 in cash savings remained at the end of 1976. The record indicates, however, that petitioner's expenditures in 1976 included the following:

Down payment on 3665 Brinkmore	$30,000.00
Furniture and appliances	31,390.47
1976 Corvette	5,408.50
Total:	$66,798.97

At the same time, petitioner's cash assets held in bank accounts increased by $3,951.09. Petitioner's expenditures in 1976 alone exceeded his alleged accumulated cash hoard plus his income from Fisher Body, and petitioner could not explain how to reconcile this fact with his testimony that he still had $20,000.00 cash at the end of 1976. Petitioner had no sources of nontaxable income to account for his increases in net worth during each of the years at issue in these cases.

Petitioner's second argument is that he contributed no money toward the purchase of (1) the dry cleaners operated by his brother J.L., (2) his mother's new house in Ozark, Alabama, (3) the swimming pool installed at that house, or (4) the two 1977 Ford LTD's purchased in 1977. Instead, petitioner theorizes that Dessie paid for portions of these items out of an alleged savings of approximately $25,000.00 from her earnings as a housekeeper. The balance was supposedly paid by J.L., petitioner's brother, who allegedly kept large sums of cash in a tool box in a hole behind the trim above the bathroom door.

Petitioner's theory is without basis in fact. In 1977, the only year in which Dessie earned income on which she was required to pay taxes, Dessie filed a Federal income tax return in which she reported wages of $2,584.40 and rental income of

$1,200.00. Dessie testified at trial that she kept her cash savings (perhaps $27,000 she said) in her girdle, in her bosom (perhaps $5,000 she said), and in a cedar chest in her house (whenever the wads in her girdle and bosom grew too large for comfort). These cash savings were supposedly used to pay for a portion of the $3,950.00 down payment on her house, a portion of the $15,000 purchase price for the dry cleaners and the 1977 Ford LTD purchased for her by petitioner in 1977.

We are unable to accord Dessie's testimony any weight. Her testimony was inconsistent as to the amounts of her savings, where the savings were kept, and how they were applied. We do not believe that Dessie could have saved the amounts claimed by her; and further, we believe that her testimony that she accumulated thousands of dollars in her bosom and her girdle bordered on perjury, being contrary in many important respects to her testimony before the grand jury that indicted petitioner. Substantial cash deposits to Dessie's accounts were made in 1975, the year in which her house was purchased and in 1976, the year in which the dry cleaners was purchased. We find these deposits came from petitioner and not from Dessie's girdle, bosom or cedar chest. Petitioner had told the real estate agent that "he wanted to buy a home for his mother"; petitioner's name appears on the title to the house. Therefore, we find that respondent properly attributed the amounts expended on behalf of

Dessie's home, the dry cleaners and her 1977 LTD to petitioner. See Friedman v. Commissioner, 421 F.2d 658 (6th Cir. 1970), affg. per curiam a Memorandum Opinion of this Court.

Similarly, J.L. testified about his own cash savings purportedly used for his mother's swimming pool, a portion of the purchase price of the dry cleaners, a portion of the down payment on his mother's house and partial payment of the two 1977 Ford LTD's purchased by petitioner in 1977 and a 1974 Ford LTD purchased by petitioner in 1974. We find J.L.'s testimony to be inconsistent, incredible and otherwise unsupported by the record. Most importantly, J.L.'s testimony is in direct conflict with his earlier testimony before the grand jury that indicted petitioner. His testimony on the income from which his savings were derived and the location of the cash savings also is contrary to his previous grand jury testimony. We conclude that J.L. did not contribute any funds to purchase those assets attributed to petitioner by respondent, and that the funds used to purchase the swimming pool, Dessie's home, the dry cleaners and the three LTD's came from petitioner. See Friedman v. Commissioner, supra.

Having negated all possible sources of nontaxable income and having pursued all leads in that regard, respondent need not establish a likely source of petitioner's income. United States v. Massie, 355 U.S. 595 (1958); Foster v. Commissioner, 487 F.2d 902 (6th Cir. 1973), affg. per curiam a Memorandum Opinion of this Court. Respondent's calculations of petitioner's net worth are well supported by the record. Petitioner has failed to suggest any sources of nontaxable income that respondent disregarded. We hold that petitioner earned taxable income for the years 1974, 1975, 1976 and 1977 and failed to report income for those years in the amounts determined by respondent and set forth in our Findings of Fact.

The remaining issue is whether petitioner's underpayment of income tax was due to fraud. Respondent must establish by clear and convincing evidence that there was an underpayment of tax and that some part of the underpayment was due to fraud within the meaning of section 6653(b).[5] Rule 142(b), Tax Court Rules of Practice and Procedure; section 7454(a). Consistent underreporting of income that is substantial in amount is indicative of fraudulent intent. Foster v. Commissioner, 487 F.2d 902 (9th Cir. 1973), affg. per curiam a Memorandum Opinion of this Court; Stone v. Commissioner, 56 T.C. 213 (1971); Otsuki v. Commissioner, 53 T.C. 96 (1969). Concealment or deception by the taxpayer also supports a finding of fraud within the meaning of section 6653(b). Spies v. United States, 317 U.S. 492 (1943); Zell v. Commissioner, 763 F.2d 1139 (10th Cir. 1985).

---

[5] Section 6653(b) provides in pertinent part:

(b) FRAUD.--

> (1) In General.--If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. * * *

1985). Respondent has established the existence of fraud for each of the years at issue in these cases by clear and convincing evidence.[6]

As discussed above, an underpayment of tax exists for each of petitioner's taxable years 1974, 1975, 1976 and 1977. Abundant evidence in the record establishes clearly and convincingly that petitioner's underpayments of tax for each of the years at issue herein were due to fraud within the meaning of section 6653(b).

Petitioner consistently underreported his income in substantial amounts and actively attempted to conceal those amounts from respondent. Petitioner attempted to hide his acquisition of certain assets by placing them in the name of nominees. Charles King was one such nominee, in whose name petitioner acquired a 1976 Chevrolet van and the property at 1655 East 79th Street. Linda Shipman was another nominee in whose name petitioner acquired a 1977 Thunderbird. Petitioner provided all funds for these assets and received no consideration from the nominee. Petitioner made false statements to respondent's agent in July of 1977 regarding petitioner's ownership of these assets. Petitioner denied owning the 1976 Chevrolet van or the 1977 Thunderbird both of which sat in his driveway when respondent's agent interviewed him and asked whether petitioner owned them. We conclude that petitioner deliberately attempted to mislead respondent's agents.

---

[6] Since petitioner pleaded guilty to the criminal tax fraud charge for the taxable year 1975, he is estopped from challenging the addition to tax for fraud with respect to that year. Gray v. Commissioner, 708 F.2d 243 (6th Cir. 1983).

The evidence establishes that petitioner consistently underreported his income, and that petitioner attempted to conceal the acquisition of various assets from respondent and made false statements to respondent's agents. Petitioner's underpayment of Federal income tax for each of the years 1974, 1975, 1976 and 1977 was due to fraud within the meaning of section 6653(b).

Decisions will be entered
for respondent.

323 COMPLETED 742-B 9 JU 11.7/2:1986-396

mf 21Ø ORIGINAL

T. C. Memo. 1986-396

UNITED STATES TAX COURT

ALLEN W. KOFTINOW, Petitioner *v*.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24071-83. Filed August 25, 1986.

C.R.E. Smith, for the petitioner.

Patricia Anne Golembiewski, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, Judge: Respondent determined a deficiency in petitioner's 1979 Federal income tax in the amount of $13,588. The issues for decision are the determination of the fair market value of property contributed to the State of California and whether petitioner is entitled to a charitable contribution deduction for other property purportedly contributed to the State of California.

FINDINGS OF FACT

Some of the facts have been stipulated, and are found accordingly. The stipulations and the exhibits attached thereto are incorporated herein by this reference. In addition to the stipulations and the trial testimony, the Court, in the presence of both counsel, viewed the contributed property.

Petitioner was a resident of Steamboat Springs, Colorado, at the time he filed his petition herein. He filed his Federal income tax return for 1979 with the Internal Revenue Service Center, Ogden, Utah. Several similarly situated petitioners in other cases have stipulated to be bound to the resolution of the issues presented herein.

Gualala Investment Company (hereinafter "Gualala"), a limited partnership of which petitioner was a limited partner, contributed a 72 foot tall statue, a quarter acre of land and a footpath easement to the State of California in December of 1979.[1] Gualala had had the statue appraised and, pursuant to the appraisal, deducted $750,000 as a charitable contribution under section 170.[2] Petitioner, on his Federal income tax return for

---

[1] The contributed property and hundreds of acres of land were acquired from a corporation in which Gualala was a 79 percent shareholder. A large portion of the acquired land had been subdivided by such corporation.

[2] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

1979, deducted $36,722, his proportionate share of Gualala's $750,000 charitable contribution deduction.

In the notice of deficiency, respondent determined that the fair market value of the contributed property at the time of the contribution was only $50,000. He disallowed $34,274 of petitioner's claimed charitable contribution deduction.

The 72 foot tall statue contributed by Gualala is entitled Expanding Universe. It was created by an Italian born artist, Beniamino Bufano. Bufano, who died in 1970, had a personality as intriguing as his art and was somewhat of a celebrity in California. Respondent's expert's report indicates that Bufano's reputation extended beyond the borders of California. Bufano's works were reviewed by British art critic Roger Fry and the noted American art critic Alfred Frankenstein. Bufano was the subject of at least five published books, one of which was published in Rome and another of which was published in Tokyo, and he was the subject of or mentioned in articles which appeared in the Saturday Evening Post, Harper's Magazine, Newsweek, Time and the New York Times. It is clear that Bufano's fame was not limited solely to California.

Expanding Universe is the largest of all of Bufano's art works. It is a 72 foot tall obeliscoid shaped concrete and mosaic statue majestically standing on the edge of a rocky cliff directly overlooking the Pacific Ocean in Sonoma County, California. Its presence on the cliff enhances the already impressive juxtaposition of the ocean, the sky, and the land.

The statue is also well within viewing distance of California State Highway No. 1. Completed in 1969, it is crowned with a reddish colored hand with fingers extended skyward. Below the hand on one side of the statue is a contoured mosaic face looking out over the ocean and a large mosaic panel which depicts a figure clothed in a long robe. On the opposite side of the statue is a larger mosaic panel. This larger panel depicts a child's face, several birds, and a haloed figure clothed in white.

OPINION

Section 170 authorizes a deduction for charitable contributions. Where a charitable contribution is made in property other than money, the amount of the contribution is generally the fair market value of the property at the time of the contribution. Sec. 1.170A-1(c)(1), Income Tax Regs. Fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Sec. 1.170A-1(c)(2), Income Tax Regs.

We will first consider the contribution of Expanding Universe to the State of California. Since respondent does not dispute that petitioner is entitled to a charitable contribution deduction in an amount equal to the fair market value[3] of the statue, our inquiry in regard to its contribution is limited to ascertaining its fair market value. Petitioner contends that the fair market of the statue is $750,000. Although respondent determined in his notice of deficiency that the fair market value of the statue was only $50,000, he now contends that the fair market value does not exceed $275,000.

---

[3] Our references to fair market value are to the fair market value at the time of the contribution.

The issue of valuation is more properly suited for the give and take of the settlement process than adjudication. Buffalo Tool & Die Mfg. Co. v. Commissioner, 74 T.C. 441, 451 (1980). The parties have decided that in this case the fair market value of the statue is better determined by adjudication.

We have closely examined the experts' reports[4] and fully considered the testimony and the arguments made by the parties as to why their opponent's expert's report is unreliable. "We may embrace or reject expert testimony, whichever, in our best judgment, is appropriate." Chiu v. Commissioner, 84 T.C. 722, 734 (1985) and cases cited therein. For the reasons stated below, we do not completely embrace either report. We do not feel that a detailed recitation of the contents of the reports will serve any purpose. Accordingly, our comments about the reports will be brief.

---

[4] Our references to the experts' reports include also the clarifying testimony given at trial by each expert as to his respective report.

The report of respondent's expert, which determined the fair market value of the statue to be between $250,000 and $275,000, is unpersuasive because it provides no convincing reasons in support of its determination. See Tripp v. Commissioner, 337 F.2d 432, 434 (7th Cir. 1964), affg. a Memorandum Opinion of this Court. Further, the report is erroneous because it values the statue in an improper market, that is a market in which the purchasers buy to resell. See Goldman v. Commissioner, 388 F.2d 476, 478 (6th Cir. 1967), affg. 46 T.C. 136 (1966); Lio v. Commissioner, 85 T.C. 56 (1985); Skripak v. Commissioner, 84 T.C. 285 (1985); and Anselmo v. Commissioner, 80 T.C. 872 (1983), affd. 757 F.2d 1208 (11th Cir. 1985).

We find the report of petitioner's expert, which determined the fair market value of the statue to be between $750,000 and $800,000, is more persuasive than respondent's expert's report. It utilized three separate methods to value Expanding Universe. The methods considered the cost, in 1979, to reconstruct a full scale replica of Expanding Universe, extrapolated the fair market value of Expanding Universe from the fair market value of Bufano's smaller art works, and considered the amounts that would be charged to create a 72 foot tall statue by comparably famous California artists such as Bruce Beasley, Tom Martin Browne, Jerome Kirk, Fletcher Benton and Mark DiSuvero.

Though persuasive, the report, in comparing the three methods, erred. The final sentence of the report states that the fair market value of the statue will approach the upper limit of the range of values determined under a particular method utilized by the report. The range of values determined under this particular method was $507,770 to $623,888. Therefore, the upper limit of this range would be approximately $600,000. Inexplicably the line immediately following the final sentence states the fair market value of the statue is $750,000 to $800,000, rather than $600,000. We view this obvious contradiction as an error. We find that had the error not occurred the fair market value of the statue as determined by the report would have been $600,000.

We feel that the $600,000 figure is reasonable and accordingly hold that the fair market value of Expanding Universe in December of 1979 was $600,000. This amount shows that the values determined under the three separate methods were not simply averaged, but rather, were weighted. We find that the relative weighting apparently used by the report is in accord with the weighting we would use to reflect our appreciation of how indicative each method was of the fair market value of Expanding Universe. Considering the lack of data more indicative of the fair market value,[5] we feel that this approach was the best way to value Expanding Universe.

---

[5] The lack of data more indicative of the fair market value of Expanding Universe is not attributable to any failure on the part of the parties. Rather, it is due to the fact that more probative evidence simply does not exist. See Hawkins v. Commissioner, T.C. Memo. 1982-451, n. 20, "Valuing a unique piece [of art work] is clearly a most difficult task, and the degree of proof which we require must be tempered by the practicalities of the situation * * *."

Having resolved the issues relating to the contribution of the statue, we now consider the contribution of the quarter acre of land and footpath easement (hereinafter "land") contributed with the statue to the State of California. For some reason, petitioner failed to produce any evidence as to the fair market value of the land. Both experts clearly testified that their valuations of the statue were determined without regard to the fair market value of the land and petitioner candidly admits on brief that no valuation evidence was presented as to the land.

Further, it appears that Gualala and petitioner failed to claim any amount on their respective returns for the contribution of the land. Gualala's partnership return for 1979 was not made a part of the record, however, the parties stipulated that Gualala claimed a charitable contribution deduction of $750,000 in 1979. Since this amount is the lowest value of the range for which the statue was appraised in 1979, we assume that the claimed charitable contribution deduction is entirely attributable to the statue. Petitioner's individual return for 1979 was made a part of the record, but in claiming the charitable contribution deduction, it fails to describe the property contributed. However, the amount of the claimed deduction exactly equals petitioner's percentage interest in Gualala times the $750,000 deduction claimed by Gualala. Accordingly, we likewise assume that petitioner's claimed charitable contribution deduction is entirely attributable to the statue.

The failure to present valuation evidence and the failure to claim charitable contribution deductions is most puzzling.[6] The record, as inadequately developed by petitioner in regard to the land, does not explain these failures.[7]

In light of the failure of petitioner to present valuation evidence with respect to the land, the failure of petitioner and Gualala to claim charitable contribution deductions for the contribution of the land, and the failure of petitioner to adequately develop the record with respect to the land, we hold that petitioner has failed to prove his entitlement to a charitable contribution deduction for the contribution of the land to the State of California.

Decision will be

entered under Rule 155.

---

[6] These failures may be attributable in part to petitioner and Gualala's beliefs that Gualala was a dealer in real estate and the basis in the quarter acre of land was zero or near zero. In such a case, sec. 170(e)(1)(A) would reduce the charitable contribution deduction for the quarter acre of land to zero or near zero. These failures may alternatively be attributable to a contribution in a prior taxable year of an interest in the land. In such a case, the contribution of the remaining interests in the land, if any, would not create a charitable contribution deduction because the remaining interests in the land, if any, would have little or no fair market value. These failures may be attributable to other reasons as well.

[7] Respondent at no point addresses the deductibility of any amount for the contribution of the land.

3 2 7 COMPLETED 12 742-B Ju 11.7/2:1986-397

#216

ORIGINAL

T. C. Memo. 1986-397

UNITED STATES TAX COURT

SELBIA A. STONE AND PHYLLIS M. STONE, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7539-77. Filed August 25, 1986.

Petitioners engaged in numerous transactions in 1969 and 1970, most of which were in connection with their real estate business. Their records and books of account clearly were inadequate. By 1972, respondent had begun to examine their tax returns, records, and books in connection with possible criminal prosecution. Both petitioners were indicted for criminal tax fraud (sec. 7201, I.R.C. 1954); petitioner-wife was tried and acquitted, and petitioner-husband's indictment was quashed. The notice of deficiency in the instant case was sent to petitioners more than 6 years after they filed their 1969 tax return and more than 3 years (but less than 6 years) after they filed their 1970 tax return.

Held: (1) Respondent has failed to prove by clear and convincing evidence that either petitioner committed fraud with intent to evade tax as to either 1969 or 1970.

(2) Respondent has proven by a preponderance of the evidence that, for 1970, petitioners omitted an amount of gross income (properly includible in their 1970 tax return) more than 25 percent of the amount of gross income stated on their 1970 tax return.

(3) The statute of limitations bars assessment of tax for 1969. Secs. 6501(a) and 6501(c)(1), I.R.C. 1954.

(4) The statute of limitations does not bar assessment of tax for 1970. Sec. 6501(e), I.R.C. 1954.

(5) Amount of deficiency for 1970 determined.

(6) No addition to tax imposed under sec. 6653(b), I.R.C. 1954.

Daniel D. Akel, *Edward C. Akel*, and *Kathleen F. Holbrook*, for the petitioners.

Ben G. Reeves, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CHABOT, *Judge*: Respondent determined deficiencies in Federal individual income tax and additions to tax under section 6653(b)[1] (fraud), as follows:

Year	Deficiency[2]	Additions to Tax Sec. 6653(b)
1969	$ 50,316.67	$25,158.34
1970	69,798.76	34,899.38

After concessions, the issues for decision[3] are as follows:

(1) Whether the assessment and collection of a deficiency for 1969 are barred by the statute of limitations

---

[1] Unless indicated otherwise, all section, subchapter, and chapter references are to sections, subchapters, and chapters of the Internal Revenue Code of 1954 as in effect for the years in issue.

[2] Of these amounts, self-employment taxes under chapter 2 are $709.57 for 1969 and $917.94 for 1970; the remaining amounts are chapter 1 income taxes.

[3] The self-employment tax adjustments and medical expense adjustments are derivative and depend both on the resolution of the issues for decision and on the settled issues.

(sec. 6501(a)) or are allowed under the fraud exception (sec. 6501(c)(1)) to the general period of limitations;

(2) Whether the assessment and collection of a deficiency for 1970 are barred by the statute of limitations or are allowed under the fraud exception or the substantial omissions exception (sec. 6501(e)(1)) to the general period of limitations; and

(3) If assessment and collection are not barred for either 1969 or 1970, then, for that year--

(a) whether petitioners received unreported taxable income in the form of commissions, forfeited deposits retained as damages, wages, capital gains, and interest;

(b) whether petitioners are entitled to deductions for certain expenses, including legal fees; and

(c) whether petitioners are liable for additions to tax under section 6653(b).

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioners Selbia A. Stone (hereinafter sometimes referred to as "Selbia") and Phyllis M. Stone (hereinafter sometimes referred to as "Phyllis"), husband and wife, resided in Chiefland, Florida.

During 1969 and 1970, Selbia, a licensed real estate broker, was engaged in the real estate business under the trade name "Exchange Realty", with his principal place of business in Ft. Lauderdale, Florida. During this period, Phyllis was a saleswoman for Exchange Realty and also ran Wholesale Homes and Apartments, Inc. (hereinafter referred to as "Wholesale Homes").[4] During this period, Exchange Realty's books and records were maintained on the cash basis and petitioners were cash basis taxpayers.

Selbia completed his formal education only through the seventh grade. Selbia was embarrassed about his lack of education and did not wish his employees or the people with whom he did business to know how little education he really had. Consequently, Selbia occasionally took home study courses and the like[5] to supplement his education, but he has never studied bookkeeping or income tax return preparation. Although Selbia was generally considered by those who knew him to be a good salesman, there is some question as to whether Selbia was also a good businessman. Selbia had little understanding of bookkeeping methods or systems. Consequently, he simply relayed pertinent information to his bookkeeper and assumed it was properly handled. Similarly, Selbia had only a slight working knowledge of the Federal income tax laws and so did not participate in the preparation of petitioners' joint tax returns filed for the years in issue.

---

[4] Petitioners treated Wholesale Homes as an electing small business corporation under subchapter S. The parties stipulate that the subchapter S election was not timely, thus the election was not effective for the years before the Court. See 70-8 Long-Term Capital Gains, infra.

[5] Selbia took a "Commercial Law" course at East Coast College in Fort Pierce, Florida, that consisted of reading a single paperback book over a three-night period. On the third night Selbia received a diploma that he hung on his office wall. Selbia took several Dale Carnegie courses in employee and public relations and hung diplomas from these courses on his office wall, too. Selbia also went to East Coast College two nights a week for about 6 weeks to prepare for the real estate salesman's State licensing exam.

Phyllis completed her formal education only through the eleventh grade,[6] including a year of bookkeeping in either the ninth or tenth grade. Although Phyllis prepared petitioners' Federal income tax returns for 1969 and 1970, she never studied income tax return preparation, except for what she could learn from pamphlets put out by the Internal Revenue Service.

Until about 1967 or 1968, Phyllis kept the books and records for Exchange Realty. However, as the company began to grow, petitioners decided to hire bookkeepers. Leslie Holl (hereinafter sometimes referred to as "Holl"), a bookkeeper,[7] was hired to work for Exchange Realty about October of 1969[8] and worked there until about September of 1970.[9] Although Selbia hired Holl, the interview was conducted by, and the job offer came from, Verna Mae Eady (hereinafter sometimes referred to as "Eady"), a saleswoman and administrative assistant for Exchange Realty. Eady told Holl what his duties were to be. Holl's duties included paying the bills, writing payroll checks, making deposits, and keeping whatever records he thought fit. Holl was given nearly complete freedom to perform these duties.

---

[6] Phyllis also took a Dale Carnegie course and the real estate salesman's State licensing exam course. See note 5, supra.

[7] Holl's educational background in accounting consists primarily of home study courses coupled with 15 years of practical experience.

[8] Petitioners had two other bookkeepers for Exchange Realty before they hired Holl.

[9] In September 1970, Holl went to work for S.E.A. Corporation, until mid-December of the same year. Selbia was president and (footnote continued)

During the time that Holl worked at Exchange Realty, Phyllis did not work there, except for the last 2 or 3 months of Holl's employment. Phyllis occasionally helped Holl keep the books at Exchange Realty, but generally only at Holl's direction. Phyllis prepared petitioners' 1969 and 1970 joint income tax returns from information supplied to her by Holl,[10] although it was often necessary for Phyllis to rewrite Holl's handwritten information to make it more legible. Neither petitioner specifically asked Holl to prepare materials for use in preparing their income tax returns. Rather, they used materials Holl had prepared for Exchange Realty or on his own initiative.

(footnote continued from previous page)
part owner of S.E.A. Corporation at the time of Holl's employment. After September 1970, Holl no longer performed any bookkeeping for Exchange Realty; however, Holl did his work for S.E.A. Corporation in Exchange Realty's offices.

[10] Holl was from England, and so he had no experience in preparing United States tax returns and forms, other than the forms for Social Security, employment, and Florida sales taxes. Holl had his own Federal income tax returns prepared by H. & R. Block.

It was standard operating procedure at Exchange Realty that for any money that came into the office, a receipt was to be prepared and the amount entered into a receipt book. The money was then deposited in one of three bank accounts maintained by Exchange Realty at the Plantation First National Bank in Fort Lauderdale, Florida: (1) the main operating account; (2) the trust account; and (3) the escrow fund account. Funds deposited in the trust and escrow fund accounts were frequently transferred to the main operating account. Deposits to the main operating account were recorded in Exchange Realty's cash receipts and disbursements journal (hereinafter sometimes referred to as "the 1969 journal") as gross receipts, whether the funds were deposited directly to the main operating account or they were transferred to the main operating account from one of the other accounts.

1. 1969 Gross Receipts--Schedule C

69-1[11] The 1969 Journal

The 1969 journal includes in its extreme right-hand column the receipts and deposits to Exchange Realty's main operating account. On the last page of the 1969 journal, in column 30, the receipts are brought forward on a month-by-month basis and totals are determined. However, there are no entries in the total receipts column for August, November, and December on the last page of the 1969 journal. Column 30, without the receipts from the omitted months, was totalled to arrive at a gross receipts figure of $106,512.96 for Exchange Realty for 1969. This is the amount reported by Phyllis on schedule C of petitioners' 1969 tax return as gross receipts from Exchange Realty for the year.[12]

---

[11] In order to facilitate reference to the notice of deficiency and the parties' briefs, we will use the same system of numbering that respondent has provided, although we do not necessarily consider the items in the same order as these numbers.

Respondent determined that $134,083.52 was income deposited in Exchange Realty's main operating account in 1969.[13]

Some of the items recorded in the receipts column of the 1969 journal are not properly items of income subject to tax.

69-2 Miscellaneous Commissions

During the audit process, revenue agent Dan Skidmore (hereinafter sometimes referred to as "Skidmore") asked Phyllis to recalculate Exchange Realty's total commission income for 1969, this time using all the files except the 1969 journal. Phyllis prepared a list using information supplied to her by Holl. Phyllis added the commissions earned by Exchange Realty, as listed on every sales contract in which Exchange Realty was involved in 1969, and calculated a total commissions amount of $99,265.86 for Exchange Realty in 1969. This amount is $7,247.10 less than the total gross receipts for Exchange Realty reported by Phyllis on petitioners' 1969 tax return. Nine of the commission items on Phyllis' list, totaling $3,684.76, had not been deposited to Exchange Realty's main operating account and, consequently, had not been recorded in the 1969 journal.

---

[12] The correct sum of the nine monthly amounts in the indicated column is $107,647.06. Petitioners have not explained the $1,134.10 difference between this sum and the total that is on the 1969 journal and their 1969 tax return.

Unfortunately, unexplained discrepancies seem to permeate the record in the instant case, including both sides' briefs.

[13] Our addition of the 1969 journal entries shows a total of $134,771.78. Respondent has conceded a $1,000 item and a $8.75 item. If these concessions were applied to our computation, then the correct total would be $133,763.03; if applied to respondent's determination, then the correct total would be $133,074.77. Yet, respondent maintains on brief that "it is agreed this correction does not reduce the total below $134,083.52 included in income by respondent." Respondent does not explain this result. Petitioners deny any such agreement; their calculations agree with ours (i.e., a net of $133,763.03).

69-3 Schwartz-Kleinberg Commission Forfeiture

In May 1969, Exchange Realty acted as the broker on a proposed transaction between Ben Kleinberg (hereinafter sometimes referred to as "Kleinberg") and Robert L. Schwartz (hereinafter sometimes referred to as "Schwartz"). As part of the sale contract, dated June 18, 1969, the buyer, Kleinberg, deposited $5,000 with Exchange Realty and agreed that, if he defaulted, then the seller (Schwartz) and the broker (Exchange Realty) would retain the $5,000 deposit as liquidated damages. Closing was to take place in 95 days (September 21, 1969). Kleinberg defaulted and forfeited the $5,000 deposit. Petitioners paid out $2,467.50 as liquidated damages to Schwartz's wife on December 22, 1969. Petitioners also refunded $5,000 to Kleinberg on September 25, 1969. Petitioners retained no part of the forfeited $5,000 deposit, and, in fact, sustained a $2,467.50 loss on the transaction.

69-4 Miller-Kleinberg Commission

In October 1969, Exchange Realty acted as broker in a transaction between Kleinberg as buyer and David Miller[14] (hereinafter sometimes referred to as "Miller") as trustee-seller. The transaction involved the sale of 86.645 acres of vacant land. An agreement between Miller and petitioners provided that a commmission of $47,654.75 would be paid--$24,300 at closing, and the balance when the purchase money mortgage payments were received by Miller from Kleinberg. The purchase money mortgage was payable in seven annual installments, beginning on or about September 25, 1970. An agreement between petitioners and Melvin I. Muroff (hereinafter sometimes referred to as "Muroff"), a real estate attorney,[15] provided that the commission on this sale would be split between petitioners and Muroff.[16] Petitioners received $24,300 at the closing between Kleinberg and Miller. Muroff increased by $12,150 the amount of a debt already owed to his wife, Gloria Muroff, by petitioners (see 70-2 Muroff-Miller Commission, infra) in order to reflect his half of the commission which he claims he never received. See table 4, infra, and accompanying discussion. No portion of this commission appears in the 1969 journal and, thus, no portion was reported as gross receipts by Phyllis on petitioners' 1969 tax return.[17]

---

[14] David Miller is the father of petitioners' son-in-law.

[15] Muroff has been engaged in the practice of law since 1953. He became acquainted with petitioners in 1968 and thereafter participated in many business dealings with them. Selbia trusted Muroff and often went to him for advice.

[16] A lawsuit by a New York broker resulted in a judgment in late 1972 against petitioners and Muroff in the amount of $15,984.50 (one-third of the total commission), plus interest of $1,760.

69-5 Joel Miller-Muroff Commission

Respondent determined that petitioners omitted $22,300 commission income from a 1969 transaction between Joel Miller and Muroff. At trial, respondent conceded this item in full.[18]

2. 69-6 and 70-7 Wages from S.E.A

S.E.A. Corporation was organized to build homes and was partially owned and operated by Selbia. Phyllis had no connection with S.E.A. Corporation. At the suggestion of petitioners' accountants, Selbia was put on the S.E.A. Corporation payroll at $100 a week salary. Since Selbia had almost always been self-employed, he intended to qualify for social security benefits some day because of the F.I.C.A. taxes withheld from his wages by S.E.A. Corporation. In 1969, S.E.A. Corporation paid to Selbia $3,300 wages, from which $588.80 was withheld as income tax and $153.60 was withheld as F.I.C.A. taxes. In 1970, S.E.A. Corporation paid to Selbia $1,700 wages, from which $252 was withheld as income tax and $81.60 was withheld as F.I.C.A. taxes.

---

[17] Respondent adjusted petitioners' gross receipts for 1969 by $12,150. Respondent does not contend that the entire $24,300 is includible in petitioners' income, despite respondent's allegations that petitioners never paid Muroff his $12,150.

[18] We include findings on conceded items which may be helpful in evaluating respondent's determinations as to fraud.

Petitioners did not report the $3,300 wages and the $1,700 wages on their 1969 and 1970 tax returns, nor did they claim credits for the withheld taxes. Petitioners never filed a refund claim for any of the withheld taxes.

Selbia did not understand the requirement that income subject to withholding must be reported on his tax return.

3. Orange Grove--Sale, Mortgage Note, Commission Note

In General

In 1962 petitioners acted as brokers on the sale of an orange grove to Harley Hartline (hereinafter sometimes referred to as "Hartline"). Hartline, as the buyer of the orange grove, was responsible for paying petitioners a $23,750 commission. In lieu of this commission, petitioners accepted from Hartline an 8.636-percent interest in the orange grove.[19] Hartline's accountant annually sent to petitioners a completed Schedule F (Schedule of Farm Income and Expenses) for the years 1962 to 1969. Some years the orange grove made money and some years it lost money. From 1962 to 1969, on balance it lost a little money (see n. 21, infra). Selbia paid his share of the overall net loss when the orange grove was sold.

---

[19] So stipulated. The Hartline-Selbia agreement, dated December 19, 1962, provides that Selbia is entitled to a $25,000 commission "upon the consummation of that certain contract, dated Jan. 16, 1963," between Hartline and the sellers of the orange grove. Of that amount, Selbia was to receive $1,250 in cash at the closing, together with an 8.636-percent interest in the orange grove.

In May 1969, the orange grove was sold to Muroff. Since petitioners acted as the brokers on this transaction, they were entitled to (1) a portion of the sales proceeds, in exchange for their 8.636-percent interest in the orange grove, and also (2) a commission on the sale of Hartline's 91.364-percent interest in the orange grove.

69-7 Capital Gain

For their 8.636-percent interest in the orange grove, petitioners were entitled to realize the amounts shown in table 1.

Table 1

Cash at closing	$ 8,401.11
Mortgage from Muroff	43,493.66
Cash for Selbia's interest in acre retained by Hartline	690.88
	$52,585.65
Less: selling expenses	6,469.53[20]
	$46,116.12

Petitioners did not actually receive any of the $8,401.11 cash at the closing, since their $1,931.58 excess of cash over selling expenses was offset against petitioners' $10,096.22[21] debt to Hartline, leaving a balance owed by petitioners to

---

[20] So stipulated. In the notice of deficiency, respondent determined that the selling expenses were $5,829.44. The $640.09 difference is described in one exhibit as "Additional Costs".

[21] The debt to Hartline was composed of the following items:

Interest on orange grove mortgage	$ 2,713.85
Loss on grove operation	3,535.51
Interest on an unrelated loan	3,846.86
	$10,096.22

Hartline of $8,164.64. Muroff's mortgage note to petitioners required payments over 10 years (beginning in 1970) and bore interest at 6 percent per year.

In May 1969, petitioners discounted the mortgage to Mary Malooley (hereinafter sometimes referred to as "Malooley") for $38,000. Muroff handled the discounting of the mortgage to Malooley, since Malooley was Muroff's client. Petitioners received a check from Malooley in the amount of $17,000. This check was deposited to the Exchange Realty trust account on October 14, 1969. Another $22,000, received by Muroff from Malooley, was credited by Muroff to a debt owed by petitioners to Gloria Muroff. See 70-2, infra.[22]

Petitioners did not report on their 1969 tax return any gain on the sale of the orange grove.

69-10 Operational Loss

Petitioners are entitled to deduct $361.68 as their share of the 1969 loss from the operation of the orange grove. Petitioners failed to deduct any such loss on their 1969 tax return.

This $361.68 is included in the $10,096.22 debt to Hartline that was paid in part on the sale of the orange grove. (See n. 21, supra.)

---

[22] It is obvious that $17,000 (the check from Malooley) plus $22,000 (the credit by Muroff) equal $39,000. Yet the parties have entered into two stipulations specifying that the mortgage was discounted for $38,000. The parties seem to recognize the discrepancy, but do not try to explain it.

Commission--1969

Exchange Realty was to receive a broker's commission of $60,363.20 for petitioners' services regarding the Hartline's interest in the May 1969 orange grove sale. In accordance with Exchange Realty's agreement with Hartline, petitioners received, on May 2, 1969, $10,000 in cash and a 10-year 6-percent note for $50,363.20. The first payment under the note was due in May 1970. Hartline's payments under the note are conditioned on his receipt of payments from Muroff under the mortgage.

On their 1969 tax return, petitioners reported the $10,000 commission that they received in cash at the closing on the orange grove sale; they did not report the remainder of the commission.

70-3 and 70-11 Commission--1970 Payment

In May 1970, Hartline was to make a payment to petitioners in the amount of $8,058.11 ($3,021.79 in interest and $5,036.32 in principal) on the commission note. Hartline also was acting as a conduit for Muroff's payments on the mortgage that petitioners had discounted to Malooley. In this capacity, Hartline was to make a payment of $6,958.99. In other words, Hartline was to make a total payment of $15,017.10, of which $6,958.99 was a mortgage payment to Malooley and $8,058.11 was a commission payment to petitioners. However, petitioners still owed Hartline $8,164.64 (see n. 21, *supra*, and related text), which debt Hartline offset against the $15,017.10 total payment due from him on both the mortgage and the commission. Thus, Hartline made a net payment of $6,852.46 directly to Malooley. Also petitioners' paid Malooley $106.53.[23]

On their 1970 tax return, petitioners failed to include the $5,036.32 commission income and $3,021.79 interest income that Hartline used to offset petitioners' debt to him. Also, petitioners did not deduct any of their payments on this debt.[24]

70-4 Commission--Schiff-Yesley Discount

The Hartline commission note, with a remaining principal balance of $45,326.88 ($50,363.20 original amount, less $5,036.32 principal payment, discussed in 70-3 and 70-11 Commission--1970 Payment, *supra*), was sold at a discount on May 25, 1970, to Eva Schiff (hereinafter sometimes referred to as "Schiff") and Selma Yesley (hereinafter sometimes referred to as "Yesley") for $32,000. Muroff handled the transaction both for petitioners and for Schiff and Yesley. Yesley is Muroff's sister. The entire proceeds from the sale of the Hartline note were to be received by Muroff from Schiff and Yesley. Petitioners were to receive the $32,000 discount price in the form of a $10,000 credit against a debt they owed to Gloria Muroff, and $22,000 in cash. The $10,000 was credited in 1970 against the balance that petitioners owed to Gloria Muroff. As to the other $22,000, see the discussions of item 70-4 in parts I (pp. 39-40) and II (pp. 61-62) in the Opinion, infra. Petitioners failed to report this transaction on their 1970 tax return.

---

[23] The $106.53 represents the part of the mortgage payment due from Hartline to Malooley that Hartline had offset against petitioners' debt.

[24] As a result of 69-10 Operational Loss, *supra* ($361.68), and the $1,931.58 application against the debt on account of the excess of cash over selling expenses, petitioners were entitled to deduct $2,293.26 of this debt against 1969 income. They did not take any such deduction on the 1969 tax return.

4. 69-9 Legal Fees

On their 1969 tax return, petitioners deducted $4,425 for legal fees. Muroff spent a great deal of time at the Exchange Realty offices.

5. 69-11 Itemized Deductions

Respondent made four adjustments to petitioners' 1969 itemized deductions, for a net adjustment increasing their deductions by $130.76. These are derivative adjustments that depend on the amount of petitioners' adjusted gross income.

6. 1970 Gross Receipts--Schedule C

70-1 Beecroft-Kleinberg Commission Forfeiture

In May 1969, Exchange Realty acted as the broker on a proposed real estate transaction between Kleinberg and Robert Beecroft (hereinafter sometimes referred to as "Beecroft"). As part of the sale contract, dated May 29, 1969, the buyer, Kleinberg, deposited $3,000 with Exchange Realty and agreed that, if he defaulted, then the seller (Beecroft) and the broker (Exchange Realty) would retain the $3,000 deposit. Kleinberg defaulted in 1970, and Beecroft was paid $1,500 out of Exchange Realty's escrow fund account. Petitioners retained the other $1,500, but did not report it as income on their 1970 tax return.

70-2 Muroff-Miller Commission

On or about January 2, 1969, petitioners bought a 40-acre orange grove called Davie Farmettes from Muroff. After various payments and mortgage assumptions,[25] a balance of $108,000 was to be secured by a purchase money mortgage. The deed was in escrow and no note or mortgage was drawn up evidencing the $108,000 debt.

At some point, Muroff transferred his interest in the $108,000 debt to Gloria Muroff, his wife.

Muroff and petitioners contemplated that petitioners would divide the 40 acres into 1-1/4-acre parcels and sell the parcels. They agreed that they would determine what would be the terms of the second mortgage for the $108,000 debt after they had an opportunity to see the rate and nature of petitioners' sales of the 1-1/4-acre parcels.

Davie Farmettes was not a successful venture. Petitioners paid about $4,000 per acre for the property. Petitioners then paid about $1,500 per acre to develop the property. Petitioners sold the 1-1/4-acre lots for about $6,000. As a result, petitioners generally were short of cash at this time.

---

[25] The original sale price of $160,000 was increased by $8,000, the amount for which Muroff had already sold an orange crop (and also increased by $378 for certain taxes). Also, petitioners paid $9,000 of the $168,378 total by sale of an orange crop. Petitioners paid $8,061.34 in cash, $1,063.76 described only as "Cooper deal", $40,393.30 by assuming an existing first mortgage on the orange grove, $1,211.80 described only as "mortgage interest accrued--last 6 mons. 1968", and $647.80 in certain stamp taxes. This left a balance due of $108,000.

In January 1970, petitioners acted as the broker on a $1,047,375 sale of real estate from Muroff to Miller. The normal commission on a sale of $1,047,375 was $104,737.50. Petitioners and Muroff agreed that petitioners would get half the commission and Muroff the other half ($52,368.75 each). The closing on this transaction was handled by Muroff, as Selbia was in the hospital at the time.

Petitioners did not report this commission as income on their 1970 tax return.

Petitioners received a warranty deed dated August 1, 1970, from Muroff and Gloria Muroff, evidencing petitioners' ownership of Davie Farmettes and stating that this ownership was "SUBJECT TO * * * A purchase money mortgage of even date herewith in the original principal amount of $83,200, in favor of Gloria Muroff." Petitioners also received a partial release of mortgage from Muroff and Gloria Muroff dated November 9, 1970, which shows an amount owed to Gloria Muroff of $83,000. This figure should have been $83,200.

Petitioners agreed to act as a broker on the sale of Muroff's lots at Davie West.[26] For each Davie West lot that they sold, petitioners were to be paid a commission of 10 percent of the amount by which the selling price of the lot exceeded $1,000.[27] Petitioners were to receive these commissions partly in the form of deposits paid by buyers of Davie West lots and partly in the form of credits against their debt to Gloria Muroff. The deposits retained by Exchange Realty on the sale of a Davie West lot often were not enough to cover the commissions due petitioners on the transaction.

---

[26] Davie West is 100 acres, north of Davie Farmettes, acquired by Muroff in a foreclosure in July 1965.

[27] The $1,000 was Muroff's approximate cost to put a housing
(footnote continued)

On March 2, 1971, Selbia and Muroff agreed that petitioners still owed $53,319 to Gloria Muroff on the Davie Farmettes mortgage.

On March 18, 1971, Selbia and Muroff agreed that petitioners still owed $42,430 to Gloria Muroff on the David Farmettes mortgage and that "this supersedes any previous accounting".

69-8 Orange Crop

Petitioners agreed to buy an orange grove, called Davie Farmettes, from Muroff for $160,000 (see 70-2 Muroff-Miller Commission, supra). This price was then increased by $8,000, the amount for which Muroff had sold an orange crop. Petitioners paid $9,000 of the total by sale of an orange crop on Davie Farmettes. In the notice of deficiency, respondent determined that petitioners had unreported ordinary income of $9,000 on account of this transaction. The parties have stipulated that respondent concedes this adjustment.

(footnote continued from previous page)
pad on each of his lots. A housing pad is a concrete pad about 70 X 70 feet on which a house could be later built.

7. 70-5 Land Received for Services

On March 10, 1970, Muroff deeded a parcel of land to petitioners in return for Selbia's services rendered in connection with his attempt to obtain a zoning change. At the time, the fair market value of the land was $17,200. On their 1970 tax return, pursuant to Muroff's advice, petitioners reported a $17,200 long-term capital gain on schedule D, and attached a statement that read "received property for services rendered on getting zoning[;] Valuation on 1.72 acres at $10,000 per acre = $17,200.00." Petitioners still held the property at the end of 1970.

8. 70-6 Other Commission Income

Apart from the commission income items discussed supra, petitioners had $43,276.87 commission income in 1970. On their 1970 income tax return, petitioners reported $45,594.87 commission income.

9. 70-8 Long-Term Capital Gains

In October 1970, petitioners sold for $11,500 a parcel of land located at 6301 S.W. 39th Court, Ft. Lauderdale, Florida, (hereinafter sometimes referred to as "the 39th Court property").

The sum of petitioners' basis and their expenses of sale is $7,843. Petitioners realized a gain of $3,657 from this sale.[28]

In August 1970, petitioners sold for $40,000 their residence, a parcel of land located at 5525 Southwest 40th Avenue, Ft. Lauderdale, Florida (hereinafter sometimes referred to as "the 40th Avenue property"). The sum of petitioners' basis and their expenses of sale is $37,364.95. Petitioners realized a gain of $2,635.05 from this sale.[29]

On schedule D of their 1970 tax return, petitioners claimed a $29,000 long-term capital loss deduction as their share of a loss suffered by Wholesale Homes. The subchapter S election for Wholesale Homes was not timely. (See n. 4, supra.)

---

[28] Petitioners incorrectly computed their long-term capital gain on this sale, as shown on the sheet attached to their 1970 tax return, as follows:

Cost	$ 7,550.00	
Sold	11,500.00	
Closing	460.00	
Int. on Mtg.	402.91	
Deprec.	377.00	
	$ 2,710.09	Profit

[29] Petitioners incorrectly computed their capital gain on this sale, as shown on the sheet attached to their schedule D, as follows:

Feb. 69 cost	$37,027.00	
Aug. 70 sold	40,000.00	
clos. cost	135.00	
Rec. fees	170.45	
Abst. fee	32.50	
Int. Hwd. Fed.	1,380.73	
	$ 1,254.32	Profit

10. 70-9 Itemized Deductions

Respondent made two adjustments to petitioners' 1970 itemized deductions for a net adjustment decreasing their deductions by $172.23.

11. 70-10 Interest Expense

On their 1970 tax return, petitioners deducted $1,783.64 of interest in connection with two sales of real estate. These interest expenses were deducted as expenses of the sales, reducing the amounts of petitioners' long-term capital gains. (See n. 28 and 29, supra.) The parties agree that these interest expenses are separately deductible from ordinary income.

12. Petitioners' Tax Returns

Petitioners' 1969 tax return was filed in July 1970; their 1970 tax return was filed on or about April 15, 1971. The notice of deficiency was mailed to petitioners on April 13, 1977, more than 3 years after the filing of petitioners' tax returns for 1969 and 1970.

On their 1970 tax return, petitioners reported the gross income (see n. 45, infra) items listed in table 2.

Table 2

Wages (Wholesale Homes)		$ 3,225.00
Interest		55.06
Gross receipts (Exchange Realty)		45,594.87
Gross sale price (real estate sales)	$ 7,256.81	
	11,500.00	
	40,000.00	
	17,200.00	75,956.81
Rents		4,458.97
Mortgages		6,885.71
		$136,176.42

13. Later Events

Respondent began his investigation of petitioners' 1969 and 1970 tax returns in 1971. Selbia felt proud that his real estate company had become big enough to be audited. By 1972, special agents were involved in the investigation. Petitioners cooperated fully with revenue agent Skidmore, and special agents Salvatore "Ted" Sparacino and Orin Oakes (hereinafter sometimes referred to "Oakes"). Not only was Skidmore furnished with an office and a desk at Exchange Realty, but all the Exchange Realty employees were instructed by Selbia to give Skidmore everything he asked for. At Skidmore's suggestion, Selbia hired certified public accountants to assist in straightening out Exchange Realty's books. When petitioners moved from Fort Lauderdale to Chiefland, Florida, in August 1971, all of petitioners' files were locked in a room to which only Skidmore and petitioners' current accountant had keys.

In 1974, respondent's Intelligence Division recommended criminal prosecution of defendants for income tax evasion for 1969 and 1970. In 1975, respondent referred the matter to the Department of Justice. Both petitioners were indicted for criminal tax evasion for 1969 and 1970. Phyllis was tried in 1976 and acquitted. Selbia's indictment was quashed.

OPINION

Petitioners have properly raised in their petition the affirmative defense of the statute of limitations under section 6501(a). Rule 39.[30]

In general, section 6501[31] bars assessment of an income tax deficiency more than 3 years after the later of (1) the date the tax return was filed or (2) the date the tax return should have been filed. If the taxpayer proves that the notice of deficiency was mailed more than 3 years after the later of the filing or the due date, then respondent has the burden of pleading and proving the existence of an exception to the general period of limitations. Farmers Feed Co. v. Commisssioner, 10 B.T.A. 1069 (1928). See Miami Purchasing Service Corp. v. Commissioner, 76 T.C. 818, 822 (1981).

---

[30] Unless indicated otherwise, all Rule references are to the Tax Court Rules of Practice & Procedure.

[31]

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(a) General rule.--Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) * * * and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

(b) Time Return Deemed Filed.--

> (1) Early Return.--For purposes of this section, a return of tax imposed by this title, * * * filed before the last day prescribed by law or by regulations promulgated pursuant to law for the filing thereof, shall be considered as filed on such last day.

In the instant case, petitioners have pled the statute of limitations as an affirmative defense in their petition and have proven that their tax returns for 1969 and 1970 were filed more than 6 years before the notice of deficiency was mailed (April 13, 1977) in the case of their 1969 tax return, and more than 5 years in the case of their 1970 return. Respondent concedes as much.

Respondent contends that the instant case falls within the exceptions to the general period of limitations set forth in section 6501(c)(1) (for both 1969 and 1970) and section 6501(e)(1)(A) (for 1970).

The parties have stipulated that, if respondent does not prove that petitioners were fraudulent, then the statute of limitations bars the assessment and collection of any deficiency for 1969. Similarly, the parties have stipulated that if respondent does not prove either fraud or that petitioners omitted an amount in excess of 25 percent of the gross income stated in their return for 1970, then the statute of limitations bars the assessment and collection of any deficiency for 1970.

We will deal first with the fraud issue, as it pertains to both 1969 and 1970, and then the substantial omission of income issue as it pertains to 1970.

I. Statute of Limitations--Fraud

Respondent raises the exception to the general period of limitations set forth in section 6501(c)(1)[32]. Respondent has the burden of proving the applicability of this exception. Farmers Feed Co. v. Commissioner, supra. This burden is the same as that which respondent bears under section 6653(b). Asphalt Industries, Inc. v. Commissioner, 384 F.2d 229, 232 (CA3 1967), revg. on other grounds 46 T.C. 622 (1966); Botwinik Brothers of Mass., Inc. v. Commissioner, 39 T.C. 988, 996 (1963). To carry this burden for a year, respondent must prove, by clear and convincing evidence, that petitioners have an underpayment of tax for that year, and that some part of that underpayment is due to fraud. Section 7454(a)[33]; Rule 142(b); e.g., Carter v. Campbell, 264 F.2d 930, 936 (CA5 1959); Stone v. Commissioner, 56 T.C. 213, 220 (1971); Otsuki v. Commissioner, 53 T.C. 96, 105, 114 (1969).

---

[32] SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

* * *

(c) Exceptions.--

(1) False return.--In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

[33] SEC. 7454. BURDEN OF PROOF IN FRAUD, FOUNDATION MANAGER, AND TRANSFEREE CASES.

(a) Fraud.--In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary.

[This language reflects amendments in 1969 and 1976 which have no effect on the instant case.]

In carrying his burden, respondent may not rely on petitioners' failure to meet their burden of proving error in respondent's determinations as to the deficiencies (e.g., Habersham-Bey v. Commissioner, 78 T.C. 304, 312 (1982), and cases there cited).

For purposes of the addition to tax under section 6653(b), fraud is not imputed from one spouse to another; in the case of a joint return, respondent must prove fraud on the part of each spouse. Section 6653(b) (last sentence) (which now appears as sec. 6653(b)(4)); Hicks Co. v. Commissioner, 56 T.C. 982, 1030 (1971), affd. 470 F.2d 87 (CA1 1972); Stone v. Commissioner, 56 T.C. at 227-228. However, respondent's proof of fraud by one spouse prevents the running of the statute of limitations under section 6501(c)(1) with regard to the other spouse. Hicks Co. v. Commissioner, 56 T.C. at 1030; Stone v. Commissioner, 56 T.C. at 228; see Goodman v. Commissioner, 71 T.C. 974, 978 (1979). Where fraud is determined for each of several years, respondent's burden applies separately for each of the years. Drieborg v. Commissioner, 225 F.2d 216, 219-220 (CA6 1955), affg. in part and revg. in part an unreported Memorandum Opinion of this Court; Estate of Stein v. Commissioner, 25 T.C. 940, 959-963 (1956), affd. sub nom. Levine v. Commissioner, 250 F.2d 798 (CA2 1958).

The issue of fraud poses a factual question which is to be decided on an examination of all the evidence in the record. Webb v. Comissioner, 394 F.2d 366, 379 (CA5 1968), affg. a Memorandum Opinion of this Court[34]; Stone v. Commissioner, 56 T.C. at 224; Stratton v. Commissioner, 54 T.C. 255, 284 (1970).

In order to establish fraud, respondent must show that the taxpayer intended to evade taxes, which the taxpayer knew or believed he or she owed, by conduct intended to conceal, mislead, or otherwise prevent the collection of the taxes. E.g., Webb v. Commissioner, 394 F.2d at 377; Powell v. Granquist, 252 F.2d 56, 60 (CA9 1958); Danenberg v. Commissioner, 73 T.C. 370, 393 (1979); Estate of Pittard v. Commissioner, 69 T.C. 391, 400 (1977); McGee v. Commissioner, 61 T.C. 249, 256-257 (1973), affd. 519 F.2d 1121 (CA5 1975). This intent may be inferred from circumstantial evidence. Powell v. Granquist, 252 F.2d at 61; Gajewski v. Commissioner, 67 T.C. 181, 200 (1976), affd. without published opinion 578 F.2d 1383 (CA8 1978); Beaver v. Commissioner, 55 T.C. 85, 92-93 (1970).

In the notice of deficiency, respondent made many adjustments to petitioners' taxable income, each of which increased petitioners' income tax liability for either 1969 or 1970.

Viewing the record as a whole, we conclude that respondent has failed to prove fraud by clear and convincing evidence, for either 1969 or 1970, by either Selbia or Phyllis.

---

[34] T.C. Memo. 1966-81.

Respondent points to the following items as support for his contentions that petitioners' income tax returns for 1969 and 1970 were fraudulent with the intent to evade tax:

1969

69-1 Petitioners knew that 3 months' gross receipts ($27,570.56; i.e., $134,083.52 minus $106,512.96 (see text at nn. 12 and 13, *supra*)) had been omitted from schedule C of their 1969 tax return.

69-2 Petitioners knew about additional commissions ($3,684.76) that were not deposited to the main account of Exchange Realty or reported as income.

69-3 Petitioners retained, but did not report, $2,500 of a $5,000 deposit forfeited by Kleinberg.

69-4 Petitioners were entitled to retain, but did not report, $12,150 of a $24,300 commission received at a closing.

69-6 Petitioners fraudulently failed to report $3,300 received by Selbia from S.E.A. Corporation.

69-7 Petitioners fraudulently failed to report a $20,631.27 capital gain from the sale of their 8.636-percent interest in an orange grove.

69-9 Petitioners knew that the amount of a $4,425 claimed legal fees deduction could not have been spent for legal fees.

1970

70-1 Petitioners retained, but did not report, $1,500 of a $3,000 deposit forfeited by Kleinberg.

70-2 Petitioners received a credit, for a $52,368.75 commission, against an outstanding debt balance owed to Gloria Muroff. Petitioners failed to report this amount as income.

70-3 and 7-11 Petitioners knew they had received payment on a commission receivable ($5,036.32) plus interest ($3,021.79) by way of a credit from Hartline on a debt owed to him by petitioners, yet they failed to report this amount as income.

70-4 Petitioners discounted a commission receivable to Schiff and Yesley and failed to report the proceeds received in the form of a $10,000 credit against the debt balance owed by petitioners to Gloria Muroff, and $22,000 in cash.

70-7 Petitioners fraudulently failed to report $1,700 received by Selbia from S.E.A. Corporation.

Although our focus is on the foregoing items, we also take into account the other adjustments since a determination of fraud is to be based on the record as a whole.

69-1 and 69-2

On the one hand, it is evident that petitioners omitted 3 months' worth of receipts from the $106,512.96 gross receipts they reported on their 1969 tax return. On the other hand, it is evident that the briefest glance at the 1969 journal would show this omission. See Iley v. Commissioner, 19 T.C. 631, 635 (1952). The parties have stipulated that "There were numerous deposits included in taxable income that should not have been." When Skidmore asked Phyllis to calculate Exchange Realty's commission income for 1969 without using the 1969 journal, Phyllis prepared a schedule totalling only $99,265.86.

Respondent's special agent (Oakes) testified that petitioners provided respondent with whatever documentation petitioners had.

Respondent has not pointed us to "clear and convincing evidence" that petitioners' correct 1969 commission income exceeded the amount petitioners reported on their 1969 tax return. Respondent has merely shown that the income might be more; on the other hand, it might be less. Respondent has persuaded us that petitioners were negligent, but has failed to persuade us by clear and convincing evidence that there was an underreporting of commission income which gave rise to a 1969 underpayment of tax due in whole or in part to fraud on the part of either petitioner.

69-3, 69-4, and 69-5

In the notice of deficiency, respondent determined three additional items of 1969 commission income, as shown in table 3.

Table 3

Transation	Amount of Commission Income
Schwartz-Kleinberg	$ 2,500
Miller-Kleinberg	12,150
Joel Miller-Muroff	22,300
	$36,950

Schwartz-Kleinberg.--Respondent points out that (1) the sale contract provides for Kleinberg's $5,000 to be liquidated damages to Exchange Realty and Schwartz, (2) Kleinberg forfeited the $5,000, and (3) Exchange Realty paid only $2,467.50 to Schwartz. This, respondent contends, supports his $2,500 commission income adjustment and petitioners' omission of this item from income is an indicium of fraud.

Respondent makes no attempt to explain away the significance of Exchange Realty's payment of $5,000 to Kleinberg just 4 days after Kleinberg forfeited the $5,000 in question. Respondent relies on a Kleinberg 1973 affidavit that he forfeited the $5,000, but there is no dispute on that point. The question is whether petitioners, through Exchange Realty, refunded the amount to Kleinberg. Kleinberg's affidavit does not discuss any possible refund. Kleinberg's affidavit refers to two other letters by him, dated January 9, 1970, but does not describe the contents of these letters. The record does not include these January 9, 1970, letters.

The only evidence as to the claimed refund is Selbia's testimony, backed up by the stipulated check.

We conclude, and we have found, not only that petitioners did not have a $2,500 profit on the Schwartz-Kleinberg transaction, but rather they sustained a $2,467.50 loss on the transaction.

There was no underpayment of income due to fraud on account of the Schwartz-Kleinberg transaction. Indeed, this transaction is evidence that contradicts fraud generally, because it shows that petitioners overreported income because they did not deduct the loss sustained on the transaction.

Miller-Kleinberg.--Petitioners received $12,150 commission income (see n. 17, supra) from this transaction in 1969 and omitted this income from their 1969 tax return. They do not explain how this could have occurred, except for their general explanation of sloppiness of records.

Under the circumstances, this omission is not itself clear and convincing evidence of fraud, but it is an indicator of fraud, to be weighed with others in evaluating the record as a whole.

Joel Miller-Muroff.--Respondent has conceded that he erred as to this $22,300 item--it is not even a proper adjustment to income, much less an indicator of fraud.

In evaluating the three asserted 1969 commission income items (totalling $36,950), we conclude that respondent has a good argument on one ($12,150) and is totally in error as to the other two ($24,800). The one item as to which respondent has a good argument will be taken into account in evaluating the record as a whole, but is not itself conclusive. See, e.g., Merritt v. Commissioner, 301 F.2d 484, 487 (CA5 1962), affg. a Memorandum Opinion of this Court;[35] Stratton v. Commissioner, 54 T.C. at 284; Otsuki v. Commissioner, 53 T.C. at 106.

69-6 and 70-7

Petitioners concede that they omitted from their 1969 and 1970 tax returns Selbia's wages from S.E.A. Corporation in the amounts of $3,300 and $1,700, respectively. Petitioners also failed to claim credit for income tax withholding in the amounts of $588.80 and $252, respectively. It is not clear whether these omissions from income result in underpayments of tax for either 1969 or 1970.[36] Selbia has been self-employed all of his working life, with the exception of this employment by S.E.A. Corporation.

We conclude that respondent has persuaded us that there was an underreporting of Selbia's wages income for 1969 and for 1970, but he has failed to persuade us by clear and convincing evidence that this underreporting gave rise to an underpayment of tax for either year due in whole or in part to fraud on the part of either petitioner.

---

[35] T.C. Memo. 1959-172.

[36] The question of whether petitioners' failure to include these wages in income results in an underpayment of taxes for either 1969 or 1970 is a direct function of where in the "stack" of income items the wages are placed.

69-7, 69-10, 70-3, 70-4, and 70-11

In lieu of a $23,750 commission earned in 1962 or 1963 (see n. 19, supra), petitioners accepted an 8.636-percent interest in an orange grove bought by Hartline. In May 1969, the orange grove was sold to Muroff. For petitioners' equity interest, they were entitled to receive cash of $8,401.11 (which was offset against selling expenses and a debt owed by petitioners to Hartline) and they received a $43,493.66 mortgage from Muroff which was subsequently discounted to Malooley for $38,000. Petitioners received the discount proceeds in the form of a credit of $22,000 against a debt owed by petitioners to Gloria Muroff, and $17,000 cash. (See n. 22, supra, for comments on the arithmetic of $17,000 plus $22,000 equals $38,000.) Also, petitioners were compensated for their brokerage services on the May 1969 transaction, by receiving $10,000 in cash and a note for $50,363.20. The first payment under the note was due in 1970. On their 1969 tax return, petitioners reported the $10,000 cash as commission income, but did not report Hartline's note and did not report anything on account of the sale of their equity interest in the orange grove.

In May 1970, Hartline made his first payment under the note ($3,021.79 interest and $5,036.32 principal) by applying the entire payment against petitioners' debts to him. (See n. 21, supra, and related text.) Also, Hartline retained $106.53 of Muroff's mortgage payment (which should have been passed on to Malooley) and applied that against petitioners' debts to

Hartline. Petitioners thereupon made up for the shortfall to Malooley by paying her $106.53. On their 1970 tax return, petitioners did not include any income or take any deduction on account of the foregoing.

Later in May 1970, Muroff arranged for petitioners to discount Hartline's note (remaining face value of $45,326.88) to Schiff and Yesley (Muroff's sister) for $32,000. Muroff acted for petitioners as well as for Schiff and Yesley. Petitioners received $10,000 of the $32,000 by having it applied against petitioners' debts to Gloria Muroff. Petitioners were to receive the remaining $22,000 of the $32,000 in cash. On their 1970 tax return, petitioners did not include any income or take any deduction on account of the foregoing.

Respondent contends that petitioners fraudulently omitted to report their 1969 capital gain on the orange grove sale. (Respondent does not dispute petitioners' 1969 treatment of the commission, i.e., reporting the $10,000 cash and not reporting the $50,363.20 note.) Respondent contends that petitioners fraudulently omitted to report the $3,021.79 interest and $5,036.32 commission that Hartline paid to petitioners on the note in 1970 (by crediting these amounts against petitioners' debts to Hartline). Respondent contends that petitioners fraudulently omitted to report the $32,000 that petitioners received in 1970 for the Hartline note.

Petitioners concede that they should have reported their 1969 capital gain on the orange grove sale, but contend that respondent substantially overstated the gain by failing to allow for petitioners' $23,750 basis in their equity interest in the orange grove. They contend that their failure to report any such gain was "simply because of an oversight"--i.e., Holl's failure to advise petitioners to report this gain. Petitioners concede that they should have reported the $3,021.79 interest and $5,036.32 on their 1979 tax return; but contend that their debt to Hartline (against which these amounts were credited) "was completely composed of expenses which would have been deductible by the Petitioners when paid." Petitioners also contend that the $106.53 they paid to Malooley was, in effect, also paid to close out their debts to Hartline. Accordingly, petitioners conclude, there is no fraud and no underpayment due to this transaction, because full reporting of the transaction would have shown $8,058.11 of additional includible income and $8,164.64 of additional deductible expenses. As a result, petitioners' errors caused an overpayment and not an underpayment. Finally, as to the discount of the note, petitioners maintain that they never received the $22,000 cash and they never received the $10,000 credit (since they had already overpaid Muroff on the Davie Farmettes mortgage).

Clearly, petitioners' omission of their orange grove capital gain from their 1969 tax return resulted in an underpayment for 1969, whether the omission was $20,631.27 (as respondent contends) or $8,436.23 (as petitioners contend).[37] This omission will be taken into account in evaluating the record as a whole, but is not itself conclusive. We also take into account the fact that petitioners, as cash basis taxpayers, were entitled to deduct the $1,931.58 that was applied against their debt to Hartline. Petitioners failed to claim this deduction, which arose from the same sale as the long-term capital gain that they failed to report.

It is true, as respondent contends, that petitioners failed to report the Hartline 1970 payment of principal and interest on their 1970 tax return. However, they also failed to deduct the related 1969 farm loss ($361.68) and the related 1970 deduction for payment of their debts to Hartline. All the components of this debt appear to be deductible when paid by cash basis taxpayers such as petitioners. See note 21, supra. The very act by Hartline that gave rise to the income (application of his payment to petitioners' debt) also gave rise to petitioners' entitlement to a deduction. If petitioners had reported these transactions on their tax returns, and had done so properly, their additional allowable deductions would have exceeded their additional includible income. Thus, items 70-3 and 70-11 not only fail to support respondent's fraud case, but rather they significantly diminish that case, for they show that petitioners' inadequate understanding of the law and of basic accounting concepts seems to have pervaded both their records and their tax returns.

---

[37] The exact amount of this capital gain requires a determination of petitioners' basis in the property sold, an issue we do not attempt to resolve. Under present law, respondent need not prove the precise amount of an underpayment, but only that there is some underpayment and that some part of it is attributable to fraud. E.g., Lee v. United States, 466 F.2d 11, 16-17 (CA5 1972); Plunkett v. Commissioner, 465 F.2d 299, 303 (CA7 1972), affg. a Memorandum Opinion of this Court (T.C. Memo. 1970-274); Kreps v. Commissioner, 351 F.2d 1, 6 (CA2 1965), affg. 42 T.C. 660 (1964).

The Schiff-Yesley purchase of the Hartline note presents us with a mystery. In May 1970, this note had a remaining face value of $45,326.88. Nine more equal annual payments were to be made, together with 6-percent interest on the unpaid balance each year. Petitioners transferred this note to Schiff and Yesley. Respondent's case as to the proceeds of petitioners' sale to Schiff and Yesley rests primarily on Muroff's testimony. Muroff testified that petitioners discounted the note because the note bore little or no interest. Yet, the note (which arose from the 1969 orange grove sale) bore the same rate of interest as the mortgage that Muroff was paying on account of his purchase of the orange grove from Hartline, presumably an arm's-length transaction. Muroff testified that the note had a weakness in that it depended on payments of the underlying mortgage obligation. Yet Muroff was the one who was obligated to make the underlying mortgage payments. Was Muroff advising petitioners that the note was not safe because Muroff might not honor his mortgage payment obligation? In the discount to Schiff and Yesley, Muroff represented both sides to the transaction, and the side opposite to petitioners included Muroff's sister (Yesley).

We wonder how much help Muroff provided petitioners. Finally, we know that Muroff received $10,000 of the proceeds, but no one seems to be able to show what happened to the other $22,000. In particular, Muroff's testimony about the transaction as a whole leads us to conclude that his claim that petitioners received the $22,000 is less likely to be true than petitioners' claim that they did not receive the $22,000.

We conclude that this third act of the orange grove tale does not furnish clear and convincing evidence of an underpayment of petitioners' 1970 income tax due to fraud. Indeed, we conclude that it is doubtful that even a preponderance of the evidence points to an underpayment due to fraud.

69-9

On their 1969 income tax return, petitioners claim a deduction of $4,425 for legal fees. On brief, petitioners assert that the correct deduction for legal fees, paid to Muroff, is $6,425. Respondent asserts that petitioners have never paid legal fees to Muroff. Petitioners do not make any effort to explain how they arrived at the $4,425 amount set forth in their tax return.

The 1969 journal shows, under the "Office exp." column, only one item designated "Legal Fees". This item appears to be the same as a stipulated Exchange Realty check, dated May 6, 1969, to Muroff for $1,425. On the check is the notation "Hartline-Kleinberg". Selbia testified that the check "was his [Muroff's] fee for handling this [Hartline-Kleinberg] transaction."

Petitoners do not tell us what the Hartline-Kleinberg transaction was. Muroff testified that he did not have any "independent recollection" of what the check was for. He testified that petitioners never paid him legal fees, that he performed legal services for petitioners without charge (except that he occasionally billed them for his costs) because "in this period of time Stone was a catalystic [sic] agent for producing many thousands of dollars of profit for me so this was by way of reciprocation that I took care of several items for him."

Petitioners have not directed our attention to any other item or items which might account for the remaining $3,000 of the deduction they claimed on their tax return.[38] Instead, they maintained at the start of the trial that they are entitled to deduct a total of $6,425 as legal fees, and focussed on a stipulated Exchange Realty check, dated October 14, 1969, to Muroff for $5,000. On the check is a notation which appears to be "change", but which Selbia testified is "charge". Selbia further testified that he paid $5,000 to Muroff for Muroff's services in the May 1969 discount of Muroff's $43,493.66 mortgage

---

[38] An exhibit introduced by respondent shows the following:

Mruoff [sic] (check 7385)	$1,425.00
check 7966	3,000.00
	$4,425.00

Check 7966 is a check to Muroff, but in the amount of $3,500, not $3,000. Petitioners do not claim that check 7966 was in payment of legal fees or is otherwise deductible. This check is listed in the 1969 journal, but is not explained; in the 1969 journal it is extended to a column that has no heading and is the only check extended to that column.

to Selbia arising out of Muroff's purchase of the orange grove from Hartline and Selbia. Muroff testified that the $5,000 check was related to the Malooley discount transaction but was not a payment for legal services. Muroff testified that the $5,000 check was an offset to two $500 checks from himself to Malooley and a $4,000 check to either petitioners or Malooley. Muroff testified that this "was a very uncommon transaction" and that that is why he was able to recollect it so long after the event.

In sum, petitioners may be entitled to little or none of their claimed legal fees deduction--or to more than they claimed. Clearly petitioners are not entitled to the precise deduction that they claimed. Each side presented some evidence on the point, but neither side's evidence is persuasive. We are left with a puzzlement, and so we hold that respondent has failed to persuade us by clear and convincing evidence that petitioners' treatment of their legal fees deduction produced an underpayment that is due to fraud.

70-1

In 1970, Kleinberg again (see discussion under *69-3*, *supra*) forfeited a deposit which was to be divided between the seller (Beecroft) and petitioners as liquidated damages. The forfeited deposit this time was $3,000. Petitioners assert that they retained no part of this $3,000 deposit. Petitioners introduced a cancelled check for $1,500 drawn on Exchange Realty's escrow account, with Robert and Ethel Beecroft as payees. We have found that petitioners retained the other $1,500 as liquidated damages and that they did not report this $1,500 on their 1970 tax return. Under the circumstances, this omission is not itself clear and convincing evidence of fraud, but it is an indicator of fraud, to be weighed with others in evaluating the record as a paid whole.

70-2

On or about January 2, 1969, petitioners bought a 40-acre orange grove called Davie Farmettes from Muroff. As a result, and after a transfer of the underlying obligation, petitioners owed $108,000 to Gloria Muroff.

In January 1970, petitioners earned a commission of $52,368.75 on a transaction between Muroff and Miller.

Petitioners received a warranty deed dated August 1, 1970, from Muroff and Gloria Muroff evidencing the ownership of Davie Farmettes subject to a purchase money mortgage of $83,200 in favor of Gloria Muroff.

Respondent maintains that petitioners received their commission from the transaction between Muroff and Miller in the form of a $52,368.75 credit against the outstanding debt balance owed by petitioners to Gloria Muroff.[39] See table 4, infra.

Petitioners assert that they did not receive the $52,368.75 commission in 1970; rather, that Muroff was to pay the commission in seven annual installments, beginning in 1973. They contend that the memorialized debt balance of $83,200 is a result of having received credit for sales commissions earned from selling Muroff's lots at Davie West. See table 5, _infra_.

---

[39] Respondent does not argue that petitioners had taxable income with regard to this $52,368.75 commission under any other theory (e.g., constructive receipt, fair market value of a negotiable note).

Table 4 shows respondent's schedule of the running balance (rounded to the nearest dollar) owed by petitioners to Gloria Muroff on Davie Farmettes.

Table 4

(Respondent's Schedule)

1969	Increase in Debt	Decrease in Debt	Balance
Second Mortgage to Muroff			$108,000
House Pads & Roads	$24,782		132,782
Advance to Ft. Lauderdale Nat'l Bank	10,000		142,782
Miller-Kleinberg Commission	12,150		154,932
Interest	8,100		163,032
Malooley Discount		$22,000	141,032
1970			
Miller-Muroff Commission		52,368	88,663
Schiff-Yesley Discount		10,000	78,663
Interest to Muroff	2,521		81,184
Lot 28 Davie West	2,400		83,584
Oct. 1970 Signed Note			83,200
1971			
Interest	1,813		85,013
Interest	3,120		88,133
Saltray Supersedeas Bond	4,606		92,739
Hotlick Payment	61		92,800
Lots Discounted to Muroff		39,420	53,380
Lots Discounted to Muroff		10,950	42,430
House Pads & Roads	10,451		52,881
Interest	519		53,400
Interest	1,917		55,317
Nardy Costs	134		55,451
Commission Due Stone		4,845	50,606
Mortgage to Doblschultz		50,500	106

Table 5 shows Phyllis' schedule of the running balance (rounded to the nearest dollar) owed by petitioners to Gloria Muroff on Davie Farmettes.

Table 5

(Phyllis' Schedule)

1969	Increase In Debt	Decrease In Debt	Balance
Balance due Muroff			$108,000
(No deed given; no mortgage signed)			
Commissions on Sales of Davie West Lots			
Laromore		$ 1,100	106,900
McConn		1,190	105,710
Lawyer		800	104,910
Compalini		700	104,210
Johnson		5,000	99,210
Knap		5,000	94,210
Molly Wein Mortgage		10,000	84,210
1970			
Commissions on Sales of Davie West Lots			
Sontora		815	83,395
Jones		890	82,505
Hennick		790	81,715
Sontora		125	81,590
Paragini		700	80,890
Montavella		1,300	79,590
Dominquez		650	78,940
Wagner		450	78,490
Vendetts		700	77,790
Ekstein		600	77,190
Stockton		1,200	75,990
Angilio		700	75,290
Burkhart		500	74,790
Interest for 1969 and 1970	$ 8,410		83,200
(July 1970, Mortgage & Note Signed. Deed Given)			
House Pads & Roads	25,000		108,200
Hartline Commission		10,000	98,200
Cannon	2,400		100,600

Table 5 (Cont.)

1971	Increase In Debt	Decrease In Debt	Balance
Cash		1,600	99,000
Commission on Sale of Lot 20		990	98,010
Lots Discounted to Muroff		39,420	58,590
Lots Discounted to Muroff		10,950	47,640
Commissions on Sales of Davie West Lots			
Lloyd		1,190	46,450
Hally		990	45,460
McConn		890	44,570
Lavoie		825	43,745
Burkhart		500	43,245
Dobleschultz Mortage		50,500	(7,255)
Interest in 1971	1,185		(6,070)
Commissions on Sales of Davie West Lots			
Mathely		890	(6,960)
Hally		810	(7,770)
Boher		1,250	(9,020)

We have difficulties in fully accepting either side's version of the events, particularly with regard to the $52,368.75.

What is established is that petitioners' debt to Gloria Muroff, was reduced by a net of $24,800 between January 2, 1969, and August 1, 1970; it was further reduced to $53,319 by March 2, 1971, and to $42,430 by March 18, 1971. Both of the 1971 agreements between petitioners and Muroff show what credits and charges were taken into account in reducing the debt from the August 1, 1970, level to the March 2, 1971, level or the March 18, 1971, level. However, neither side has produced evidence of a similar agreement showing how the August 1, 1970, level of $83,200 was reached. Petitioners' record-keeping was thoroughly inadequate. Muroff, a lawyer, could be expected to be aware of the importance of keeping records, especially with regard to a substantial open account. As early as December 1972, respondent's special agent was conducting an investigation of petitioners' income taxes for the years here in issue. Presumably, Muroff's records would still have been available at that time.

The only exhibit which appears to be more-or-less contemporary, and which supports respondent's version of the events, is a document in Holl's handwriting which shows in a sketchy fashion how the balance of the debt was reduced to $78,663.25. In constructing what we have set forth as table 4, supra, respondent then adds "Interest to Muroff 2521.60" and "Lot 28 Davie West 2400--" to the $78,663.25, which results in a balance of $83,584.85. The next entry on this schedule is the agreement that the debt balance is $83,200, with no explanation of the $384.85 discrepancy.

Petitioners counter with a document that Phyllis had prepared contemporaneously from information that Holl had passed on to her from Muroff. This document shows the balance of the debt being reduced to $74,790. Phyllis then arrives at the October 1, 1970, level of $83,200 by adding "Interest for 69 & 70 8,410.00" to the $74,790.

In October 1969 the Miller-Kleinberg transaction produced a $47,654.75 commission, of which $24,300 was paid at the closing. This commission was to be split evenly between petitioners and Muroff. Petitioners failed to report any part of the 1969 receipt of this commission. Petitioners claim that they paid

Muroff $12,150; they concede that the remaining $12,150 is taxable to them. Respondent seems to contend that petitioners kept the entire $24,300 yet respondent contends only that $12,150 was income to petitioners.

If respondent's notice of deficiency adjustment is correct, that petitioners had $12,150 commission income from the Miller-Kleinberg transaction, then petitioners are correct in their contention that they paid the remaining $12,150 to Muroff, and Muroff should not have debited the debt. On the other hand, respondent's schedule takes into account Muroff's claimed debit of the $12,150. If that treatment is correct, then petitioners must have kept the entire $24,300 and respondent should have adjusted petitioners' income by the full amount.

Thus, respondent's schedule is inconsistent with the notice of deficiency in its treatment of Muroff's share of the 1969 portion of the commission from the Miller-Kleinberg transaction; however, respondent's schedule is consistent with our findings on this point.

Petitioners' schedule does not show the $12,150 item at all.

We have found, and petitioners do not dispute, that in May 1969 petitioners discounted to Malooley a $43,493.66 mortgage that they had acquired earlier in the year, that Muroff kept $22,000 out of the proceeds of that discounting, and that he applied this $22,000 as a credit against the debt. This application to the debt is memorialized in an agreement signed by

Selbia and Muroff, and dated October 14, 1969. Phyllis' schedule does not give effect to this credit. Respondent's schedule takes this credit into account.

Respondent's schedule shows a 1969 debit of $24,782, to reflect Muroff's business' charge for roads and house pads (concrete slabs on which purchasers of Davie Farmette lots would be expected to build their houses). Phyllis' schedule shows a $25,000 debit for this purpose, but shows it as a 1970 adjustment, made after the striking of the $83,200 balance. Phyllis' adjustment is inconsistent with the Muroff-Selbia agreements of March 2, 1971, and March 18, 1971. Further, on brief petitioners contradict Phyllis' schedule by contending that the "amounts listed in the 'Increase in Debt', column for house pads or roads that Broward Land Clearing Co. allegedly constructed on the Davie Farmettes property * * * were never owed by petitioners to Mr. Muroff, as Broward Land Clearing Co. never completed any roads and only two house pads on the Davie Farmettes Property."

We have found, and both sides agree, that on May 25, 1970, petitioners sold the Hartline note to Schiff and Yesley for $32,000. There is a dispute as to whether Muroff kept the entire $32,000 or paid $22,000 over to petitioners. (See 69-7, 69-10, 70-3, 70-4, and 70-11, supra.) However, everyone agrees that Muroff kept $10,000 and credited this amount against the debt. Presumably this would have been done at or shortly after the May 25, 1970, date of the Schiff-Yesley transaction and, thus, well before the October 1970 agreement that the debt balance was $83,200. Respondent's schedule is consistent with our findings in that it shows the $10,000 credit as one of the 1970 adjustments taken into account in arriving at the November 9, 1970, agreement for an $83,200 balance. Phyllis' schedule is inconsistent with our findings in that it shows the $10,000 as a 1970 adjustment after the $83,200 balance.

Phyllis' schedule shows credits for commissions earned by petitioners on the sales of Muroff's Davie West lots; respondent's schedule does not show any such credits.

Muroff testified that these commissions were not credited to petitioners' debt because they were paid "up front" in the form of a deposit by the buyer (and retained by Exchange Realty) on each Davie West lot sold. However, we note that, contrary to Muroff's testimony in this regard, the deposits retained by Exchange Realty on the sale of a Davie West lot often were not enough to cover the commissions due petitioners on the transaction. Also, for many of the commissions claimed as credits by petitioners there is no corresponding receipt in the record evidencing that petitioners also received a deposit. Similarly, for many of the deposits received by petitioners there is no corresponding claims that the commission was also a credit against their outstanding debt. In other words there is little overlap between the commissions claimed by petitioners to have been credited against their outstanding debt balance and the commissions claimed by Muroff to have already been paid to petitioners in the form of retained deposits. We find additional support for petitioners' contention that some of their commissions from Davie West sales were credited to their Davie Farmettes balance, in a statement by Eady, an Exchange Realty salesperson, that she was not sure she ever received all the commissions due her on the sale of Davie West lots "due to the fact that Mr. Muroff was crediting Stone's account."

If we were to modify respondent's schedule by factoring in the Davie West commission credits, then respondent's schedule, as so modified, would show a debt balance significantly lower than the agreed-upon $83,200 amount.

If this issue were to be decided on the basis of the preponderance of the evidence, then we would conclude that each side's explanation is significantly flawed, that the question is a close one, but that it is somewhat more likely than not that petitioners did receive a credit for the $52,368.75 against the debt they owed to Gloria Muroff, and so petitioners should be required to take this amount into income for 1970. However, fraud requires clear and convincing evidence. We conclude that respondent has not met his burden of proving by clear and convincing evidence that petitioners' $52,368.75 commission was properly includible in petitioners' 1970 tax return or that their failure to include this commission results in an underpayment of tax due to fraud.[40]

---

[40] We note that both sides' schedules show amounts for interest in their respective "Increase in Debt" columns, albeit in (footnote continued)

70-5

Respondent determined that petitioners had received $41,125 as "Value of Land Received for Services". At trial, respondent conceded that the land was worth only $17,200. Petitioners reported this $17,200 as a long-term capital gain, but noted on their tax return that they had received it for services. As respondent implicitly acknowledges, petitioners' error in this regard is not evidence of fraud. We believe this error to be consistent with petitioners' general confusion about record-keeping and tax-return preparing.

70-8 and 70-10

Petitioners erred in deducting a pass-through subchapter S capital loss and in understating their long-term capital gains on two sales. Because of the $1,000 limit on deductions of capital losses against ordinary income (sec. 1212(b), as then in effect), petitioners derived little tax benefit from their errors. Also, a significant portion of their understatement of long-term capital gains on the two sales resulted from petitioners' treatment of interest as an expense of sale, instead of as a separate fully deductible expense. Petitioners' error in the

---

(footnote continued from previous page)
different amounts and at different times. Voluntary partial payments on debts generally are treated as first applying to interest and then to reduction of principal. Motel Corp. v. Commissioner, 54 T.C. 1433, 1440 (1970); Bayou Verret Land Co. v. Commissioner, 52 T.C. 971, 985 (1969), affd. in part and revd. in part on other issues 450 F.2d 850 (CA5 1971). Petitioners' payments on their debt to Muroff are to be treated as payments of interest, deductible as such, in accordance with this general rule. The parties are to determine the amounts so deductible, in the Rule 155 computation.

treatment of their interest expense was an error in respondent's favor. As respondent implicitly acknowledges, petitioners' long-term capital gains errors are not evidence of fraud.

Conclusions

In the notice of deficiency, respondent made adjustments for 1969 totalling $105,069.17. On brief, respondent breaks this down into 11 adjustments to taxable income. We agree with respondent's adjustment 69-4, that petitioners omitted $12,150 that they received. We agree with respondent's adjustment 69-6, that petitioners omitted $3,300 that Selbia received as wages from S.E.A. Corporation; however, petitioners are to be credited with the $588.80 that had been withheld from these wages. We agree with respondent's adjustment 69-7 that petitioners omitted their long-term capital gain on the sale of their interest in the orange grove; however, the amount of the gain is unclear[41] and respondent failed to allow petitioners to deduct the $1,931.58 that was applied against their debt to Hartline. Respondent concedes two other adjustments (69-5 and 69-8), totalling $31,300. Of the six remaining adjustments, we have found in one (69-3) that petitioners overstated their income by $2,467.50, rather than understating it by $2,500 as respondent determined; we have held in three (69-1, 69-2, and 69-9) that respondent failed to prove by clear and convincing evidence that there were underpayments due to fraud; and in two (69-10 and 69-11) respondent determined that petitioners overstated their income.

---

[41] Respondent determined that petitioners' taxable income should be increased $20,631.27. It may be that the increase should be as little as $8,436.23.

In the notice of deficiency, respondent made adjustments for 1970 totalling $136,968.47. On brief, respondent breaks this down into 11 adjustments to taxable income. We agree with respondent's adjustment 70-1, that petitioners omitted $1,500 that they retained in the Kleinberg-Beecroft transaction. We agree with respondent's adjustment 70-4 that petitioners omitted $10,000 in the Schiff-Yesley transaction that they received by way of Muroff crediting this amount against petitioners' debt to Gloria Muroff; however, we agree with petitioners that respondent erred as to the remaining $22,000. We agree with respondent's adjustment 70-7, that petitioners omitted $1,700 that Selbia received as wages from S.E.A. Corporation; however, petitioners are to be credited with the $252 that had been withheld from these wages. Of the three remaining fraud items, we have held in two (70-3 and 70-11) that petitioners were required to include in income amounts credited against debts to Hartline but simultaneously became entitled to deduct these amounts, and we held in 70-2 that respondent failed to prove by clear and convincing evidence that there was an underpayment due to fraud. The five remaining items, all nonfraud, include two overstatements of income (70-10 and 70-6), one where respondent conceded the bulk of the adjustment and petitioners' error as to the rest was patent on the return (70-5), a derivative adjustment (70-9), and a small capital gain adjustment (70-8).

We have found that petitioners cooperated with respondent during the investigation. There is no evidence that petitioners failed to turn over any records to respondent or that petitioners attempted to falsify records or otherwise mislead respondent's agents. See Stratton v. Commissioner, 54 T.C. at 287; Marinzulich v. Commissioner, 31 T.C. 487, 492-493 (1958). See also Muste v. Commissioner, 35 T.C. 913, 921 (1961). Petitioners not only instructed all Exchange Realty employees to give respondent's agents everything they asked for, but petitioners also hired certified public accountants to help respondent straighten out Exchange Realty's books.

Were the issue before us, and particularly in light of the different standard of proof required, we would be inclined to impose the addition to tax for negligence or intentional disregard of rules and regulations under section 6653(a). However, that is not this case.[42] Negligence, whether slight or great, is not equivalent to the fraud with intent to evade tax named in the statute. The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing. Mere negligence does not establish either. Webb v. Commissioner, 394 F.2d at 377; Carter v. Campbell, 264 F.2d at 935-936; Thurston v. Commissioner, 28 T.C. 350, 355 (1957).

---

[42] See Bishop v. Commissioner, T.C. Memo. 1986-2.

Respondent has not proven that petitioners were fraudulent for either 1969 or 1970. Consequently, respondent cannot rely on the exception set forth in section 6501(c)(1) to the general period of limitations set forth in section 6501(a). Since respondent relies on only the fraud exception for 1969, we hold that the statute of limitations bars the assessment and collection of any deficiency for 1969. Because we have concluded that the assessment for 1969 is barred by the statute of limitations, we do not reach the issue of unreported income for 1969.

We hold for petitioners on this issue.

II. Statute of Limitations--Substantial Omission

Since we have found no fraud for 1970, respondent cannot rely on the exception set forth in section 6501(c)(1) to the general period of limitations in section 6501(a). Respondent has alleged in the alternative, that he is entitled to the 6-year period provided for in section 6501(e)(1)(A)[43] for 1970. The generally applicable 3-year period is extended to 6 years when there has been an omission from gross income of "an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return." Section 6501(e)(1)(A). In the case of a trade or business, "gross income" means gross receipts, prior to diminution by cost of goods sold. Section 6501(e)(1)(A)(i).

---

[43] SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

* * *

(e) Substantial Omission of Items.--Except as otherwise provided in subsection (c)--

(1) Income taxes.--In the case of any tax imposed by subtitle A--

(A) General rule.--If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income

(footnote continued)

The parties agree that, if respondent proves the 25-percent omission, then the statute of limitations does not bar assessment; otherwise, it does. The burden is on respondent to establish by a preponderance of the evidence that the 6-year statute is applicable. Stratton v. Commissioner, 54 T.C. at 289; Philipp Bros. Chemicals, Inc. (Md.) v. Commissioner, 52 T.C. 240,

---

(footnote continued from previous page)

> stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph--
>
> (i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and
>
> (ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

[The subsequent amendment of this provision by section 1906(b)(13)[sic](A) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1834, does not affect the instant case.]

254-255 (1969), affd. 435 F.2d 53 (CA2 1970); Williamson v. Commissioner, 27 T.C. 647, 659, 662-663 (1957); see Peters v. Commissioner, 51 T.C. 226, 230 (1968). The 6-year statute of limitations applies to both spouses on a joint tax return where respondent proves that a sum was "properly includible" in the aggregate gross income of the joint taxpayers and exceeds 25 percent of the gross income reported. Benjamin v. Commissioner, 66 T.C. 1084, 1100-1101 (1976), affd. 592 F.2d 1259 (CA5 1979).

Respondent asserts that the gross income stated in petitioners' 1970 tax return is $81,384[44] and that 25 percent of this amount is $20,346. Respondent contends that petitioners have omitted far more than $20,346 from their 1970 tax return. Respondent does not point specifically to the items that back up this assertion, but insists that the statute of limitations is open under the exception provided under section 6501(e)(1)(A).

Petitioners assert that their total omissions from gross income for 1970, for purposes of section 6501(e)(1), are $9,751.11, which is made up of $3,021.79 of interest income (70-11), $5,036.32 of commission income (70-3) and $1,700.00 in wages

---

[44] Respondent presents the following breakdown of the "amount of gross income stated in the return":

Wages		$ 3,225
Interest		55
Gross Receipts (Schedule C)		45,595
Gains (Schedule D)	$ 2,710	
	1,254	
	17,200	21,164
Rents		4,459
Mortgage Income		6,886
		$81,384

from S.E.A. Corporation (70-7). (Note that these three items total $9,758.11, not $9,751.11. See n. 12, supra.) Petitioners do not indicate what the amount of gross income stated on their 1970 return is, but are confident that $9,751.11 is not in excess of 25 percent of this amount. Consequently, petitioners conclude that respondent has failed to carry his burden of proving that the 6-year limitation period under section 6501(e)(1) is applicable.

We agree with respondent's conclusion.

70-1

In 1970, Kleinberg forfeited a $3,000 deposit that was to be divided between Beecroft and petitioners as liquidated damages. We found that petitioners retained $1,500 of this deposit as liquidated damages. We hold that this $1,500 is an omitted item properly includible in petitioners' gross income for 1970.

70-2

In 1970, petitioners acted as the broker on a sale from Muroff to Miller. Petitioners thereby were entitled to receive a commission of $52,368.75. Respondent contends that petitioners received this commission by way of a credit against their debt to Gloria Muroff. Petitioners contend that they never received any part of this commission. In our analysis of the fraud issue, supra, we concluded that respondent failed to prove by clear and convincing evidence that this commission was properly includible in petitioners' 1970 income. However, we also stated as follows:

> If this issue were to be decided on the basis of the preponderance of the evidence, then we would conclude that each side's explanation is significantly flawed, that the question is a close one, but that it is somewhat more likely than not that petitioners did receive a credit for the $52,368.75 against the debt they owed to Gloria Muroff, and so petitioners should be required to take this amount into income for 1970. However, fraud requires clear and convincing evidence.

Since respondent's burden of proof on the 6-year statute of limitations question is to prove the omission by a preponderance of the evidence, and since respondent has carried this burden of proof, we hold that, for purposes of the 6-year statute of limitations, petitioners have omitted $52,368.75 that is properly includible in their gross income for 1970.

70-3 and 70-11

In May 1970, petitioners received a payment of $8,058.11 ($5,036.32 principal; $3,021.79 interest) from Hartline on a $50,363.20 note representing partial payment of the commission petitioners earned on the sale of the orange grove. Notwithstanding our conclusion that an equal amount is allowable as a business expense deduction not claimed on their tax return, petitioners concede, and we hold, that this entire payment was omitted from their gross income for 1970, though properly includible for that year.

70-4

With regard to the discounting to Schiff and Yesley of the $50,363.20 note received as a partial payment for a commission earned by petitioners, we found, and so conclude, that petitioners received a $10,000 credit in 1970 against a debt owed to Gloria Muroff. Respondent contends that petitioners also received $22,000 in cash as a result of the Schiff-Yesley discount. We observed petitioners and their records. We observed respondent's witness, Muroff. In part I of this opinion, supra, we commented on the evidence as we see it. We conclude that petitioners' denials of receipt are more believable than Muroff's claims.

We hold that petitioners omitted $10,000 that was properly includible in their gross income for 1970 but that they did not omit the other $22,000 determined by respondent.

70-7

Petitioners concede that they omitted $1,700 in wages paid to Selbia in 1970 by S.E.A. Corporation, and that these wages are properly includible in their gross income for 1970.

The remaining items are not omissions from gross income (note that item 70-6, discussed in part III of the opinion, infra, is not an omission item since it substitutes $43,276.87 for the $45,594.87 that petitioners reported on their 1970 tax return), although some of them affect the deficiency to be determined.

To summarize, we conclude that petitioners omitted $73,626.86 of items that were properly includible in their 1970 gross income, as shown in table 6:

Table 6

$ 1,500.00 -- Kleinberg-Beecroft liquidated damages
52,368.75 -- credit--Muroff-Miller commission
8,058.11 -- credit--Hartline note payment
10,000.00 -- credit--Schiff-Yesley discount
1,700.00 -- wages--S.E.A. Corporation
$73,626.86

We have concluded that the aggregate of the gross income items reported on petitioners' 1970 tax return is $136,176.42. Petitioners omitted from their gross income $73,626.86. Respondent has carried his burden of proving that petitioners omitted "from [their 1970] gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return," and so the 6-year statute of limitations applies and 1970 is not closed by the statute of limitations.

We hold for respondent on this issue.[45]

III. Deficiency for 1970

In part I of this opinion, respondent had the burden of proving, by clear and convincing evidence, that there was an underpayment, some part of which was due to fraud; respondent failed to carry this burden. In part II, respondent had the burden of proving, by a preponderance of the evidence, that petitioners omitted from their 1970 tax return an amount of gross income which exceeds 25 percent of the gross income stated in their tax return; respondent carried this burden. In this part, petitioners have the burden of proving, by a preponderance of the evidence, that respondent erred in his notice of deficiency determinations as to matters of fact. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

---

[45] Respondent contends that petitioners stated on their 1970 tax return only $81,384 of gross income. (See n. 44, *supra*.) The difference between this amount and the amount shown in our findings in table 2, *supra*, depends (apart from rounding-off changes) on the application of section 6501(e)(1)(A)(i) to the capital gain and loss transactions that petitioners reported on schedule D attached to their tax return. Since 1970 is not closed by the statute of limitations even if we were to apply section 6501(e)(1)(A)(i) in a manner most favorable to petitioners, it would serve no purpose to analyze how that provision should be applied in the instant case. See *Insulglass Corp. v. Commissioner*, 84 T.C. 203 (1985).

70-1

Respondent determined that petitioners omitted $1,500 that they had retained on account of a forfeiture of liquidated damages by Kleinberg. We found that petitioners did receive and retain this amount and did not report it as income.

We hold for respondent on this issue.

70-2

Respondent determined that petitioners omitted $52,368.75 that had been earned as commission on a sale of real estate from Muroff to Miller; Muroff paid petitioners by crediting this amount against a debt owed by petitioners to Gloria Muroff. In part I of this opinion, we held that respondent had failed to prove by clear and convincing evidence that this commission was includible in petitioners's income. However, in part II of this opinion, we held that respondent had proven by a preponderance of the evidence that this commission was includible in petitioners' income. Necessarily, petitioners have failed to prove by a preponderance of the evidence that respondent erred in his determination.

We hold for respondent on this issue.

70-3 and 70-11

Respondent determined that petitioners omitted Hartline's payment of $5,036.32 principal and $3,021.79 interest on his commission note to petitioners; Hartline paid petitioners by crediting their debts to him. We found that petitioners received this payment and did not report it as income. We also found that they did not deduct Hartline's crediting of petitioners' debt, and that they did not deduct the $106.53 that they paid to Malooley on Hartline's behalf, thereby eliminating their debt to Hartline.

We agree with respondent on this inclusion; we agree with petitioners on the deduction.

We hold for petitioners on this issue.

70-4

Respondent determined that petitioners omitted $32,000 that they received from Schiff and Yesley in exchange for the Hartline note, which had a remaining principal balance of $45,326.88. Of this $32,000, petitioners were to receive $10,000 by way of a credit against their debt to Gloria Muroff, and $22,000 in cash. We found that petitioners received the $10,000 credit and they failed to report it on their tax return.

As we stated in part II, supra, we hold for respondent as to the $10,000 and we hold for petitioners as to the $22,000.

70-5

Respondent determined that petitioners had received land in exchange for services, that the land had a fair market value of $41,125, and that petitioners failed to report it on their tax return.

Petitioners reported on their tax return that they received land in exchange for services. On Muroff's advice, they reported the transaction as a capital gain, on schedule D. To avoid even the appearance of misleading, they attached a statement to their tax return stating that they "received property in exchange for services rendered". They valued the land at $17,200.

Respondent has conceded that the land's value was $17,200 (as petitioners had reported), and not $41,125 (as respondent had determined). Petitioners have conceded that they erred in reporting the $17,200 as a capital gain; it should have been reported as income in exchange for services.

This item is to be treated in accordance with the parties' concessions; i.e., ordinary income is to be increased by $17,200 and capital gains are to be decreased by $17,200.

70-6

Respondent determined that, in addition to the commission income dealt with in items 70-1 through 70-5, petitioners had commission income of $43,276.87. From the $175,306.94 total that respondent determined for items 70-1 through 70-6, respondent subtracted the $45,594.87 that petitioners reported on their tax return. Petitioners dispute respondent's determinations as to items 70-1 through 70-5, but agree with his treatment of item 70-6.

We have set forth, supra, our determinations as to items 70-1 through 70-5. Item 70-6 is to be treated in accordance with the parties' agreement.

70-7

Respondent determined that petitioners omitted $1,700 in wages that Selbia had received from S.E.A. Corporation. We found that Selbia received these wages and that petitioners omitted them from their tax return. However, we also found that S.E.A. Corporation withheld $252 income tax and $81.60 F.I.C.A. taxes from these wages. It is not clear from the notice of deficiency whether respondent made any allowance for these withholdings.

We hold for respondent as to the additional income. However, we also hold that petitioners are to be given credit for the $252 withheld income tax; also, in calculating the amount of Selbia's self-employment taxes, petitioners are to be given credit for the withholding of the self-employment taxes from these wages.

70-8

Respondent determined that petitioners had long-term capital gains totalling $6,292.05. After the then-applicable 50-percent deduction of section 1202, this resulted in increasing petitioners' adjusted gross income by $3,146.02. Since petitioners reported capital losses and deducted $1,000 from adjusted gross income, respondent's adjustment was $4,146.02. Petitioners concede that they erred in reporting smaller amounts of capital gains[46] and in reporting a "pass-through" subchapter S corporation loss. However, petitioners contend that (contrary to what they reported on their tax return) they are entitled to "roll over" the gain on the sale of one of the properties. Petitioners have failed to carry their burden of proof.

We hold for respondent on this issue.

70-9

Respondent determined that petitioners overstated their itemized deductions by $172.23, but that this is solely derivative, and depends on our resolution of other adjustments. Petitioners agree. This is to be modified in the Rule 155 computation, in accordance with our determinations as to the other adjustments.

---

[46] Petitioners reported capital gains of $2,710.09 and $1,254.32 (for a total of $3,964.41) instead of $3,657 and $2,637.05 (for a total of $6,292.05). As to one property, petitioners improperly subtracted $377 of previously claimed depreciation from the sale price, instead of from the basis. Thereby, they reduced the capital gain by $754. Petitioners also erroneously subtracted interest payments totalling $1,783.64 from the sales prices, thereby erroneously increasing their capital gain but also depriving themselves of an ordinary deduction for the interest. Petitioners also made other errors which increased by $210 the capital gain they reported.

70-10

Respondent determined that petitioners are entitled to deduct $1,783.64 as interest expense; petitioners had erroneously treated it as expenses of selling certain capital assets. (See n. 46, supra.) The parties agree that the notice of deficiency is correct on this item, and we so hold.

IV. Additions to Tax

Respondent determined that petitioners are liable for additions to tax under section 6653(b) for 1969 and 1970.

We held in part I that respondent failed to carry his burden of proving by clear and convincing evidence that petitioners committed fraud as to either 1969 or 1970. Although part I deals with the fraud exception to the statute of limitations (sec. 6501(c)(1)), that conclusion applies equally to the fraud addition to tax. See Asphalt Industries, Inc. v. Commissioner, supra; Botwinik Brothers of Mass., Inc. v. Commissioner, supra.

Petitioners' tax returns, records, and books of account were prepared or maintained negligently. However, respondent did not choose to proceed under section 6653(a) (negligence, etc.), even by way of alternative. Accordingly, even though 1970 is not closed by the statute of limitations, we do not have authority to impose any addition to tax on account of negligence. See section 6214(a).

We hold for petitioners on this issue.

* * * * * * * *

To the concern that all liability for tax for 1969 should not be avoided because respondent failed to bear his burden of proof as to fraud, we make the following response. Firstly, the interaction of the statute of limitations with the requirements as to fraud represents a compromise between two public policies determined by the Congress. People should be required to pay their tax liabilities. But the Congress also has provided "that after a determinate period of time citizens can rest assured that their tax returns will not be reopened by zealous tax officials." Kreps v. Commissioner, 351 F.2d at 4. Secondly, by December 1972, respondent's investigation of petitioners' 1969 income tax liabilities had proceeded to the point that respondent's Intelligence Division was conducting formal recorded interviews of Selbia, Phyllis and Holl. Petitioners' 1969 tax return was filed in July 1970. A notice of deficiency mailed by July 1973 would still have been within the general 3-year statute of limitations period for 1969. Section 6501(a). A notice of deficiency mailed by July 1976 would still have been within the special 6-year statute of limitations; respondent would have the burden of proof, but only by a preponderance of the evidence. Respondent chose to run the risk of the statute of limitations and to rely on the fraud exception to the general rule, with its inherent burden of proof by clear and convincing evidence.

Section 6501(c)(2). The result we reach in the instant case is caused by respondent's failure to carry the burden of proof that respondent chose to assume.

Decision will be entered
under Rule 155.

323

742-B

Ju 11.7/2: 1986-398

COMPLETED

9

AUG

r 216

ORIGINAL

T. C. Memo. 1986-398

UNITED STATES TAX COURT

J. JEFFREY PRESS AND CAROL PRESS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 39273-84. Filed August 25, 1986.

J. Jeffrey Press, pro se.

William S. Garofalo, for the respondent.

MEMORANDUM OPINION

WILLIAMS, Judge: The Commissioner determined a deficiency in petitioners' Federal income tax for the taxable year 1976 in the amount of $3,682.00. The sole issue this Court must decide is whether respondent issued the statutory notice of deficiency to petitioners after the applicable statute of limitations had expired.

The facts of this case have been fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure, and are so found. Petitioners resided at Upper Montclair, New Jersey at the time the petition in this case was filed.

Petitioners were members of a joint venture, the Little Mud Pond Swamp Joint Venture ("Joint Venture"). The organizational agreement executed by petitioners on October 19, 1976 stated that the members of Joint Venture would own, as tenants in common, a leasehold interest in land in New Jersey to mine peat. Petitioners acquired a .24% interest in Joint Venture.[1]

The members of Joint Venture each contributed capital to the venture. Losses were allocated to the members in proportion to their respective capital contributions to the venture. Profits were allocated to the members in accordance with a schedule required to be set forth in the executed organizational agreement. Petitioners did not take production in kind or contract to sell on an individual basis their share of any production.

Joint Venture appointed Green Gro of Greenwich, Inc. (Green Gro), a member of Joint Venture, as its agent. Green Gro, as lessee, executed a mining lease with Euro-Continental

---

[1] The organizational agreement in the record is a sample agreement which fails to specify capital contributions, allocations of profit and loss or the members of Joint Venture. The parties stipulated, however, that petitioners acquired their interest in Joint Venture.

BEST COPY AVAILABLE

Investments, Ltd. on October 19, 1976. The lease granted to Green Gro the exclusive right to mine peat from a 30-acre plot of land in Sussex County, New Jersey.

Frank J. Pitassi, president of Green Gro, submitted a letter to respondent on October 19, 1976 stating "We hereby elect under Section 761d to be excluded from Part Subchapter K." Joint Venture was not identified in the letter. The letter listed some of the investors in Joint Venture but did not include petitioners. Joint Venture did not file a Form 1065, U.S. Partnership Return of Income.

On March 15, 1980 petitioners executed a Form 872-A, Special Consent to Extend the Time to Assess Tax, for petitioners' Federal income tax for the taxable year 1976. The agreement to extend the statute of limitations was limited in scope as follows:

> Any assessment of an increase in the above tax for the taxable period(s) covered by this agreement is to be limited to the amount resulting from any adjustment to: (a) the taxpayer's distributive share of any item of income, gain, loss, deduction, or credit of, or distribution from any partnership (or any organization treated by the taxpayer as a partnership on the taxpayer's tax return); and (b) the tax basis of the taxpayer's interest(s) in such partnership(s) or organization(s) treated by the taxpayer as a partnership, including any consequential changes to other items based on such adjustment.

Respondent's notice of deficiency in this case was mailed on August 22, 1984. The deficiency was based on respondent's determination that petitioners' distributive share of the claimed $4,044,000.00 loss from Joint Venture, reported on their 1976 Federal income tax return as $9,706.20, was zero.

Petitioners do not dispute the deficiency but assert that assessment of the tax is barred by the statute of limitations. Arguing that the Form 872-A executed by the parties extended the statute of limitations only with respect to partnership items or items in connection with organizations treated as partnerships on petitioners' 1976 return, petitioners contend that Joint Venture was not a partnership and was not treated as such by petitioners on their return. Petitioners conclude that the loss from Joint Venture was not an " * * * item of * * * loss * * * from any partnership" within the meaning of the agreement of the parties as set forth in the Form 872-A. Consequently, in petitioners' view, respondent's notice of deficiency, determining an adjustment to the loss claimed from Joint Venture, was untimely.

In general, respondent must issue a notice of deficiency in Federal income tax within three years after a taxpayer's return has been filed. Section 6501(a).[2] The bar of the statute of limitations is an affirmative defense, on which petitioner bears the burden of persuasion and the initial burden of going forward with the evidence. Adler v. Commissioner, 85 T.C. 535 (1985).

---

[2] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year at issue in this case, unless otherwise indicated.

Petitioners' joint Federal income tax return for the taxable year ended December 31, 1976, dated April 14, 1977, was deemed to have been filed on April 15, 1977. Section 6501(b). Respondent's notice of deficiency with respect to petitioners' 1976 return was mailed to petitioners on August 22, 1984, more than three years after petitioners' 1976 return was filed. This showing satisfies petitioners' initial burden of going forward.

Petitioners, however, executed a Form 872-A, Special Consent to Extend the Time to Assess Tax, on March 15, 1980, less than three years after their 1976 return was filed. This consent extended the time during which respondent could assess income tax due with respect to partnership items on petitioners' 1976 return. This consent satisfies respondent's burden of going forward. Adler v. Commissioner, supra. Therefore, petitioners must establish that the executed Form 872-A does not extend the statute of limitations with respect to the deficiency determined in this case.

Petitioners contend that Joint Venture elected pursuant to section 761 to be excluded from the partnership provisions of subchapter K of the Internal Revenue Code of 1954, and that because Joint Venture was, therefore, not to be taxed as a partnership, an adjustment to the loss claimed from Joint Venture was not included within the scope of the Form 872-A extension.

We agree with petitioners that the Form 872-A executed by the parties extends the statute of limitations only for adjustments of partnership items or of items in connection with an organization treated as a partnership on petitioners' 1976 return. We cannot agree, however, that Joint Venture elected not to be treated as a partnership pursuant to section 761(a).[3]

A valid election pursuant to section 761(a) must include a statement of election filed with a properly executed partnership return, Form 1065, which must identify the names, addresses and identification numbers of all members of the organization, state that all members elect to be excluded from subchapter K of the Internal Revenue Code of 1954, and state that the organization qualifies under section 761(a) to make the election. Section 1.761-2(b)(2)(i), Income Tax Regs. Further, an election will be deemed to have been made "if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation" to make an election pursuant to section 761(a). Section 1.761-2(b)(2)(ii), Income Tax Regs.

---

[3] On this basis, we do not reach the issue of whether Joint Venture was an organization qualified to make an election pursuant to section 761(a); and, furthermore, we do not consider the effect of such an election, if validly made, on the Form 872-A executed by petitioners.

Joint Venture failed to satisfy the requirements of respondent's regulations. Pitassi's letter to respondent contained none of the information required by the regulations. Notably, it failed to identify Joint Venture and all of its members. The record is barren of evidence indicating any intent of all of the members of Joint Venture or any intent of petitioners to make such an election at the time the joint venture was formed. Therefore, we find that Joint Venture did not make an election pursuant to section 761(a) to be excluded from subchapter K of the Internal Revenue Code of 1954.

Having found the purported section 761 election to be ineffective, we must determine whether Joint Venture is a partnership for Federal income tax purposes. This Court is not bound by state law definitions to determine if an entity is a partnership for Federal tax purposes. Commissioner v. Tower, 327 U.S. 280 (1946). A joint venture may not be a partnership under state law, but for Federal income tax purposes, it is included in the definition of "partnership." Long v. Commissioner, 77 T.C. 1045, 1064-1065 (1981); Podell v. Commissioner, 55 T.C. 429, 431 (1970). The term "partnership" is defined in section 7701(a)(2) as follows:

> (2) PARTNERSHIP AND PARTNER.--The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

See also section 761(a). Ten years ago the Second Circuit commented that "It is well settled * * * that for tax purposes a joint venture is treated as a partnership. [Footnote omitted.] Sections 761(a) and 7701(a)(2) of the Code, 26 U.S.C. §§ 761(a) and 7701(a)(2)." Rodman v. Commissioner, 542 F.2d 845, 854 (2d Cir. 1976).

The documents in the record state that Joint Venture was organized to carry on the business of mining peat, and petitioners do not argue that the members of Joint Venture did not intend to carry on any business. The members of Joint Venture each contributed capital to the venture. The claimed loss was shared and allocated among its members. Petitioners were allocated their distributive share of Joint Venture's claimed loss for 1976. These facts compel the conclusion that for Federal income tax purposes Joint Venture was a partnership. Madison Gas and Electric Co. v. Commissioner, 633 F.2d 512 (7th Cir. 1980), affg. 72 T.C. 521 (1979). Therefore, the adjustment to the claimed loss from Joint Venture was properly within the limited scope of the Form 872-A extension executed by the parties. Respondent's notice of deficiency in this case was timely.

Accordingly,

Decision will be entered
for respondent.

323 COMPLETED 742-B JU 11.7/2: 1986-399
18
83-16

ORIGINAL

T. C. Memo. 1986-399

UNITED STATES TAX COURT

ROBERT SCOTT CRONHARDT AND DIANA MARGARET CRONHARDT, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24039-82. Filed August 25, 1986.

Robert Scott Cronhardt, pro se.

David L. Lau, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CLAPP, Judge: Respondent determined deficiencies in petitioners' 1978 and 1979 Federal income taxes in the amounts of $15,439 and $18,111, respectively. The issues for decision are: (1) whether petitioners' rental of real property was an activity engaged in for profit; (2) whether petitioners' horse operations constituted an activity engaged in for profit;[1] and (3) whether petitioners' gain on the sale of their principal residence must be recognized.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and the exhibits attached thereto are incorporated by this reference.

Petitioners resided in Rogue River, Oregon at the time they filed their petition in this case.

Petitioner-husband worked for Ford Aerospace and Communications Corporation (Ford Aerospace). He planned to retire from Ford Aerospace in 1979 or 1980. Petitioners thought that their income would be insufficient after petitioner-husband retired. Thus, they decided that they would need a new source of income and that a horse ranch would provide the additional income they would need.

---

[1] Respondent disallowed investment tax credits in 1978 and 1979 on equipment and structures petitioners utilized for their horse operations. Respondent disallowed petitioners' 1978 moving expense deduction. The expenses were incurred when petitioners moved from Colorado to Oregon to start their horse operations full time. Respondent disallowed the investment tax credits and moving expense deduction because petitioners' horse operation was not an activity engaged in for profit. See sections 38 and 217. Thus, the resolution of these issues is controlled by our determination in issue 2.

In a related case involving the taxable years 1980 and 1981, respondent disallowed losses from petitioners' horse operations because he contends that they were not engaged in for profit. For the taxable years 1980 and 1981 which are now docketed in this Court, the parties have stipulated to be bound by the relevant findings of fact and conclusions of law of this opinion.

In May 1971, petitioners purchased land in Rogue River, Oregon (the Oregon ranch) which they planned to use for a horse ranch after petitioner-husband retired. In September 1971, while petitioner-husband worked for Ford Aerospace, petitioners purchased a ranch in Morgan Hill, California (the California ranch). Petitioners resided at the California ranch until Ford Aerospace transferred petitioner-husband to Colorado in 1973. In October 1977, petitioners purchased a ranch in Peyton, Colorado (the Colorado ranch). Petitioner-wife moved to the Oregon ranch in December 1978. Petitioners sold the Colorado ranch in January 1979. Petitioner-husband resigned from Ford Aerospace and moved to the Oregon ranch in February 1979.

Rental Property

In May 1971, petitioners purchased the Oregon ranch which had 35 acres of land and a house. Petitioners rented the house and land separately; they rented the house to a tenant from 1971 to 1979 and the land to farmers from 1973 through 1978 as follows:

Period	Usage
1973-1974	Field Crops and Cattle Grazing
1975-1976	Not rented
1977	Hay Production
1978	Cattle Grazing

In anticipation of moving to the property in 1980, petitioners made periodic improvements to the land as follows:

Year	Improvements
1976	Underground irrigation system, planting with orchard grass/clover mix, pump/irrigation pipe
1977	Fence repair
1979	Cross fencing installation, barn/ arena construction

On Schedule F of their 1978 Federal income tax return, petitioners reported income and expenses from their rental operations as follows:

Income		
Rental of house and land		$1,960.00
Expenses		
Repairs, maintenance	$ 253.00	
Supplies purchased	451.00	
Fuel (10,421 miles)	1,772.00	
Taxes	109.00	
Insurance	183.00	
Freight, trucking	100.00	
Land cleaning expenses	697.00	
Abandonment-fence	1,393.00	
Board and Lodging	345.00	
Telephone	19.00	
Airfare	333.00	
Misc. Expenses	93.00	
Depreciation (house & equipment)	$5,956.00	
Total expenses		$11,704.00
Net Oregon Property Profit (Loss)		($ 9,744.00)

On a separate Schedule F of their 1978 Federal income tax return, petitioners reported income and expenses from their horse activity at their Colorado ranch as follows:

Peyton, Colorado Property

Income		
Sales of Hay		$ 120.00
Expenses		
Repairs, maintenance	$ 687.00	
Feed purchased	1,288.00	
Supplies purchased	399.00	
Breeding fees	550.00	
Vet. fees, medicine	1,271.00	
Fuel (16,084 miles)	2,658.00	
Taxes and licenses	46.00	
Insurance	79.00	
Utilities	371.00	
Freight, trucking	687.00	
Telephone	117.00	
Dues and Subscriptions	48.00	
Show Expense	135.00	
Farrier	104.00	
Board for horses	6,020.00	
Labor-training	3,222.00	
Advertising	266.00	
	$17,948.00	
Depreciation (on horses, property & equipment)	4,938.00	
Total expenses		$22,886.00
Net Colorado Property Profit (Loss)		($22,766.00)

In 1979, the house remained rented but petitioners used the land for their horse operations. On Schedule F of their 1979 Federal income tax return, petitioners reported the combined income and expenses from the rental and horse operations as follows:

Income

Sales of Hay	$ 860.00	
Rental of House	800.00	
Rent of Pasture	459.00	
Sale of Colt	1,850.00	
		$3,969.00

Expenses

Repairs, maintenance	1,204.00	
Feed purchased	1,314.00	
Fertilizer, lime, chemicals	246.00	
Supplies purchased	1,791.00	
Breeding fees	1,100.00	
Veterinary fees, medicine	1,045.00	
Fuel	2,185.00	
Taxes and Licenses	286.00	
Insurance	425.00	
Utilities	643.00	
Freight, trucking	351.00	
Board & Lodging	150.00	
Casual labor	254.00	
Equipment Rental	1,061.00	
Advertising	1,166.00	
Board of Horses	6,955.00	
Training of Horses	5,785.00	
Dues & Subscriptions	480.00	
Depreciation (horses, house & equipment)	$8,072.00	
Total Expenses		$34,513.00
Net Oregon Property Profit (Loss)		($30,544.00)

Horse Operations

Petitioners decided to acquire experience in various horse activities while petitioner-husband worked at Ford Aerospace and, to engage in horse operations full time after petitioner-husband retired. To acquire experience, petitioners purchased the California, Colorado and Oregon ranches.

Petitioners resided and kept five horses, three appaloosas and two quarterhorses, at the California ranch. They also kept two horses at a breeding ranch in Idaho. In 1973, Ford Aerospace transferred petitioner-husband to Colorado. Petitioners sold the horses located at the California ranch and moved to a home in Colorado Springs, Colorado. The two horses located in Idaho were transported to Colorado and boarded at a horse ranch.

Upon moving to Colorado, petitioners attempted to locate a ranch. In October 1977, petitioners purchased the Colorado ranch which had 15 acres. While in Colorado, petitioners purchased eight horses, sold four horses, and their horses had six foals.

Petitioner-wife moved to the Oregon ranch on December 28, 1978 in anticipation of their entering the horse business full time. Petitioners sold their Colorado ranch on January 5, 1979. Petitioner-husband lived in an apartment while he remained in Colorado to finish his assignment with Ford Aerospace. Upon completion of his assignment, he resigned from Ford Aerospace and moved to the Oregon ranch on February 5, 1979.

At the California and Colorado ranches, petitioners performed the normal duties of cleaning stalls, grooming and feeding. They also purchased, sold and bred horses.

The following chart reflects petitioners' horses which were foaled, purchased and/or sold:

NAME	PURCHASE ($)	DATE	DEPR. ($)	SELLING ($)	DATE	NET ($)
Go's Elsano	400	(7/71)	-	250	(1/76)	(150)
Ring O'Fire	900	(8/71)	346	600	(12/74)	46
Miss Bammy Bar	500	(8/71)	900	-	-	-
Maya Monday	foal	(4/72)	-	350	(3/74)	350
About to Win	855	(5/72)	305	600	(9/75)	50
Nug Waggoner	655	(5/72)	148	400	(1/74)	(107)
Doc's Moonraker[2]	foal	(4/73)	3500	-	-	-
Miss Moonlight Jet	foal	(3/74)	417	725	(4/77)	1142
Shes Otoes Flash	1000	(11/74)	310	245	(4/77)	(445)
Melodys Mamie	2700	(8/75)	2700	-	-	-
Docs Marauder	foal	(3/76)	-	1850	(12/79)	1850
Tivio Prince	foal	(4/76)	-	800	(4/77)	800
Spanish Sin	2500	(7/76)	2083	put down	(10/82)	(417)
Docs Monarch	foal	(4/77)	-	5500	(10/80)	5500
Jans Melody	foal	(4/77)	-	4500	(1/80)	4500
Anna B Badger	2350	(5/77)	1899	750	(1/83)	299
Skips Gray Ghost	-	(5/77)	-	traded for training	(12/81)	-
Skips Judy	1000	(5/77)	190	814	(10/78)	4
Skips Interest	1750	(6/77)	1100	1050	(1/83)	400
Skips Mary Ann	1000	(8/77)	489	650	(5/81)	139
Shasta Skipadoo	600	(9/77)	539	-	-	-
Mildady Doc	foal	(4/78)	-	-	-	-
A Skip Named Sue	foal	(3/79)	-	-	-	-
Moonrakers Star	foal	(5/79)	-	750	(5/81)	750
Moonrakers Bucky	foal	(3/80)	-	1850	(5/84)	1850
Docs Nomad	foal	(4/80)	-	-	-	-
Moonrakers Knight	foal	(4/80)	-	933	(5/82)	933
Skip To The Doc	foal	(6/80)	-	750	(5/81)	750
Docs Copper Cutter	foal	(4/81)	-	-	-	-
Docs Classy Sox	foal	(4/81)	-	1000	(7/84)	1000
Skippza Doll	foal	(5/81)	-	put down	(6/82)	-
Shasta Summer	foal	(5/81)	-	650	(1/83)	650
Bruces Moonraker	foal	(4/82)	-	traded for training	(2/84)	-
Docs Cascade Lady	foal	(5/82)	-	775	(1/83)	775
Shastas Misty Lady	foal	(5/82)	-	-	-	-
Docs Cascade Bar	foal	(5/83)	-	-	-	-
Unnamed	foal	(3/84)	-	-	-	-
Unnamed	foal	(4/84)	-	-	-	-
Unnamed	foal	(4/84)	-	-	-	-

---

[2] The parties have spelled Doc's Moonraker with and without an apostrophe. We use the spelling the parties use in the stipulation of facts.

Petitioners conducted horse breeding as follows:

MARE	SIRE	FOAL
Miss Bammy Bar	(Purchased 8/71)	
	Docs Dynamo	Doc's Moonraker (4/73)
	Cosmo Jet	Miss Moonlight Jet (3/74)
	Docs Dynamo	Doc's Marauder (3/76)
	Docs Dynamo	Doc's Monarch (4/77)
	Docs Dynamo	Milady Doc (4/78)
	Docs Wapati	Doc's Nomad (4/80)
	Docs Wapati	Doc's Copper Cutter (4/81)
	Docs Tivio Bar	Doc's Cascade Bar (5/83)
Melody's Mamie	(Purchased 8/75)	
	Poco Tivio	Tivio Prince (4/76)
	Docs Moonraker	Jan's Melody (4/77)
	Docs Moonraker	Moonraker's Buck (3/80)
	Docs Moonraker	Bruce's Moonraker (4/82)
	Docs Moonraker	Unnamed (4/84)
Spanish Sin	(Purchased 7/76)	None
	(put to sleep)	
Anna B. Badger	(Purchased 5/77)	
	Son O Skip	Skip's Gray Ghose (5/77)
	Son O Skip	A Skip Named Sue (3/79)
	Docs Moonraker	Moonrakers Knight (4/80)
	Docs Moonraker	Docs Classy Sox (4/81)
Skip's Interest	(Purchased 6/77)	
	Docs Moonraker	Skippza Doll (5/81)
Skips Mary Ann	(Purchased 8/77)	
	Doc's Moonraker	Moonrakers Star (5/79)
	Docs Moonraker	Skip to the Doc (6/80)
Shasta Skipadoo	(Purchased 9/77)	
	Doc's Moonraker	Shasta Summer (5/81)
	Docs Moonraker	Shastas Misty Lady
		Unnamed (3/84)
Milady Doc	(Foaled 4/78 from Miss Bammy Bar)	
	Sir Skipa	Unnamed (4/84)
Go's Elsano	(Purchased 8/71)	Maya Monday (4/72)

While petitioner-husband was employed by Ford Aerospace, petitioners worked 30 hours per week on their horse operations. They worked 55 hours per week on their operations after petitioner-husband retired.

Petitioners maintained complete and accurate books and records of their activities. They culled their herd. They advertised through trade publications and by sending their prize horse to stallion parades.

Petitioners reported the results of their horse operations on their Federal income tax return as follows:

Year	Net Income (Loss)
1971	(5,710)
1972	(7,731)
1973	(8,299)
1974	(10,573)
1975	(16,691)
1976	(17,314)
1977	(19,481)
1978	(32,484)
1979	(30,544)
1980	A loss, but the loss was less than the year before
1981	A loss, but the loss was less than in 1980

Petitioners' operations were impacted adversely by two events: petitioner-husband was transferred from California to Colorado in 1973 and their prize horse broke its leg in 1975. Petitioners shifted their emphasis from horse sales to horse and cattle boarding to make their operations profitable.

Petitioners' adjusted gross income before taking into account their Schedule F losses was as follows:

Year	Amount
1978	$ 73,377
1979	$ 54,502
1980	Approximately $20,000
1981	Approximately $20,000

Deferred Gain on Sale of Principal Residence

Petitioners bought a house in Colorado on July 16, 1973 and a second residence in Colorado on October 4, 1977. They sold the first house for a gain on December 5, 1977. On their 1977 Federal income tax return petitioners claimed nonrecognition of the gain pursuant to section 1034.

Petitioners conducted horse operations at their second residence. As part of their operations, they depreciated fencing, a barn and an outbuilding. They sold the second residence to its original owner on January 5, 1979, 13 months after the sale of the first house. Petitioners realized a gain on the sale of the residence including the depreciated property. On Form 2119 of their 1979 Federal income tax return, they claimed nonrecognition of the entire gain.

ULTIMATE FINDINGS OF FACT

Petitioners' rental of real property was not an activity engaged in for profit.

Petitioners' horse operation was an activity engaged in for profit.

OPINION

The first two issues for decision are whether petitioners' rental of real property and operations involving horses were activities engaged in for profit within the meaning of section 183.

Section 183(a)[3] provides generally, if an activity is not engaged in for profit, no deduction attributable to such activity shall be allowed except as otherwise provided for in that section. Section 183(c) defines "activity not engaged in for profit" as "any activity other than one with respect to which deductions are allowable * * * under section 162 or * * * paragraph (1) or (2) of section 212." Section 1.183-2(b), Income Tax Regs., provides a list of nine factors to consider in the determination of whether an activity is engaged in for profit.[4] However, the resolution of the issue is to be based on all the facts and circumstances. Engdahl v. Commissioner, 72 T.C. 659, 666 (1979). In order for the taxpayer to prevail, the facts and circumstances must indicate that the taxpayer entered into, or continued, the activity with an actual and honest objective of making a profit. Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983).

---

[3] All references to sections are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

[4] The factors are:

(1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved.

Rental Property

Petitioners purchased the Oregon property with the intention of using it for their horse operations when petitioner-husband retired from Ford Aerospace. Petitioners were able to rent the land to farmers in 1973, 1974, 1977 and 1978. The land was not rented in 1975 or 1976. During this two-year hiatus, petitioners upgraded the land in anticipation of their moving to it in 1980. Petitioners rented the house on the land from 1971 through 1979.[5]

Petitioners' concern for the property focused primarily on its future use as a horse farm. Its ability to generate rental income was fortuitous, and only of second importance. Although petitioners mitigated the carrying costs of the land from the time of purchase to the time they moved to Oregon through rent income and tax deductions, they did not enter into, or continue, the rental of the property with an actual and honest objective of making a profit.

Horse Operations

Petitioners wanted a steady income after petitioner-husband retired from Ford Aerospace in 1980. To effect their desire, they decided they would work full time in various horse related activities after petitioner-husband retired. They, however, did not want to begin their horse operations full time without first gaining some experience.

---

[5] It appears that the rental property involved two separate activities: the rental of land and the rental of a house. Neither party has raised this issue and, consequently, we analyze the rental operations as a single activity.

Petitioners gained a great deal of experience at the California and Colorado ranches. They participated in the daily chores and bred, purchased and sold horses. Petitioners' efforts to gain experience prior to undertaking the activities full time are an indication that their activities were engaged in for profit.

At each of their ranches, petitioners carried on their activities in a business like manner. They kept complete and accurate books and records. They culled their herd. They advertised through trade publications and by sending their prize horse to stallion parades. Finally, they took steps to make their business profitable by shifting their emphasis from horse sales to horse and cattle boarding.

Petitioners expended a substantial amount of time and effort in carrying on their horse operations. They worked 30 hours per week on their horse activities while petitioner-husband was employed by Ford Aerospace and 55 hours per week after they moved to the Oregon ranch.

Although petitioners' operations have a history of losses, petitioners' operations were impacted adversely by petitioner-husband's transfer to Colorado and their prize horse's suffering a broken leg. Petitioners' largest losses occurred in 1978 and 1979. These large losses, however, can be attributed in part to petitioners' shifting their operations from part time to full time and the nonrecurring expenses associated with this transition. The losses began to decrease in the years immediately following 1978 and 1979.

Finally, although petitioners had an adjusted gross income, before taking into account their Schedule F losses, of $73,377 and $54,502 in 1978 and 1979, respectively, their income decreased dramatically after petitioner-husband retired from Ford Aerospace. Thus, petitioners' financial status does not clearly indicate whether or not petitioners' operations were engaged in for profit.

Based on the entire record, we find that petitioners' horse operations were engaged in for profit.

Deferred Gain on Sale of Principal Residence

Realized gains on the sale or exchange of property are generally recognized. Section 1001(c). An exception to the general rule is that realized gains are not recognized if they result from the sale or exchange of a principal residence pursuant to section 1034. Section 1034(a), as in effect in 1979, provided in relevant part:

> (a) Nonrecognition of Gain.--If property (in this section called "old residence") used by the taxpayer as his principal residence is sold by him and, within a period beginning 18 months before the date of such sale and ending 18 months after such date, property (in this section called "new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price * * * of the old residence exceeds the taxpayer's cost of purchasing the new residence.

Section 1034(d)(1), however, renders subsection (a) inapplicable if petitioners utilized the nonrecognition provisions of section 1034 within the 18 month period prior to the sale of their second residence.[6] Section 1034(d)(1). Furthermore, the limitation in section 1034(d)(1) does not apply, and the realized gain in question is not recognized, if section 1034(d)(2) applies. Subsection (d)(2) provides:

> (d) Limitation.--
>
> * * *
>
> (2) Subsequent Sale Connnected With Commencing Work at New Place.--Paragraph (1) shall not apply with respect to the sale of the taxpayer's residence if--
>
> (A) such sale was in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work, and
>
> (B) if the residence so sold is treated as the former residence for purposes of section 217 (relating to moving expenses), the taxpayer would satisfy the conditions of subsection (c) of section 217 (as modified by the other subsections of such section).

Section 217 (c) provides:

---

[6] In 1979, subsection 1034(d)(1) provided:

> (d) Limitation.--
>
> (1) In General.--Subsection (a) shall not apply with respect to the sale of the taxpayer's residence if within the 18 month period before the date of such sale the taxpayer sold at a gain other property used by him as his principal residence, and any part of such gain was not recognized by reason of subsection (a).

> (c) Conditions for Allowance.--No deduction shall be allowed under this section unless--
>
> (1) the taxpayer's new principal place of work--
>
> (A) is at least 35 miles farther from his former residence than was his former principal place of work, or
>
> (B) if he had no former principal place of work, is at least 35 miles from his former residence, and
>
> (2) either--
>
> (A) during the 12-month period immediately following his arrival in the general location of his new principal place of work, the taxpayer is a full-time employee, in such general location, during at least 39 weeks, or
>
> (B) during the 24-month period immediately following his arrival in the general location of his new principal place of work, the taxpayer is a full-time employee or performs services as a self-employed individual on a full-time basis, in such general location, during at least 78 weeks, of which not less than 39 weeks are during the 12-month period referred to in subparagraph (A).
>
> For purposes of paragraph (1), the distance between two points shall be the shortest of the more commonly traveled routes between such two points.

In the present case, section 1034(d)(1) would, but for subsection (d)(2), apply because petitioners utilized section 1034 when they sold their first house--13 months prior to selling their second residence. However, subsection (d)(2) applies. Subsection (d)(2)(A) is met because petitioners sold their second residence in connection with their move to Oregon to become self-employed in their full-time horse business. Subsection (d)(2)(B) is met because petitioners move from Colorado to Oregon meets the 35-mile distance requirement of section 217(c)(1) and petitioners activities lasted at least through 1981 which satisfies the 24-month time requirements of section 217(c)(2).

Because section 1034(d)(2) applies, section 1034(d)(1) does not apply and section 1034(a) applies. The realized gain on the sale of petitioners' principal residence is not recognized. Finally, to the extent any assets in the sale were not part of petitioners' principal residence and were part of petitioners' horse operations, section 1034 does not apply, e.g., any gain is realized from the sale of the depreciated fencing, barn, and outbuilding.

To reflect the foregoing,

Decision will be entered

under Rule 155.

323

742-B

Ju 11.7/2: 1986-400

COMPLETED

6

AUG 28 1986

mf 217

ORIGINAL

T. C. Memo. 1986-400

UNITED STATES TAX COURT

PANO ANASTASATO AND JANICE ANASTASATO, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 14631-81. Filed August 26, 1986.

Alan H. Levine, for the petitioners.

Jack H. Klinghoffer, for the respondent.

SUPPLEMENTAL MEMORANDUM OPINION

KÖRNER, Judge: In Anastasato v. Commissioner, T.C. Memo. 1985-101, we sustained the Commissioner's determination that override payments were made by KLM Royal Dutch Airlines ("KLM") during the years 1974 through 1976 to Panmarc, a corporation wholly-owned by petitioner Pano Anastasato ("Pano"), and through it to Pano.

We concluded that -- since the Commissioner had established, by admissible and substantive evidence, that petitioners were directly linked to the income-producing activity which was the basis for respondent's determination of additional unreported income -- the Commissioner's statutory notices of deficiency were entitled to their usual presumption of correctness. Having previously noted that the presumption of correctness attaching to the notice of deficiency is procedural and places on petitioners the burden of proof to show that respondent's determination is incorrect, we held, inter alia, that since

> [p]etitioners herein presented no affirmative evidence to demonstrate any error in respondent's said determinations, having contented themselves throughout this trial with attacking only the basis for respondent's determinations, rather than the accuracy thereof * * * [the] determinations of deficiency must be upheld. [49 T.C.M. 893, 901; 54 P-H Memo. T.C. par. 85-101 at 464-85.]

Petitioners Pano and Janice Anastasato appealed our decision to the Court of Appeals for the Third Circuit.[1/] While affirming our decision on all other points as to which appeal was taken, including our holding that the burden of proof was on petitioners to show error in respondent's determination of deficiencies, but not as to respondent's determination of additions to tax for

---

[1/] Petitioner Janice Anastasato originally filed her appeal in the Eleventh Circuit. That Court, on February 3, 1986, transferred this appeal to the Third Circuit, which consolidated it with Pano's appeal. Panmarc, the other petitioner before us, did not appeal.

fraud, the Third Circuit vacated our decision and remanded the case to this Court, based on its interpretation of the above-quoted language as indicating that:

> the court believed that, once the Commissioner was granted the usual [presumption] of correctness, the question whether the taxpayer received the alleged unreported income no longer remained at issue and only the amount of the assessment could be considered. [Slip op. at 8; 749 F.2d 884, ___, 86-2 USTC par. 9529 at 85,142; 58 AFTR2d 86-5347, 86-5352 (3d Cir. 1986).]

The Court stated that

> it was possible that the taxpayer could ultimately prevail by proving that while he engaged in the activity in question he never received the income in question.
>
> It is possible that the Tax Court, on proper consideration of the taxpayer's denial of receipt of income, will find such denials improbable. Nevertheless, because the court did not explicitly or implicitly reject the taxpayers' testimony, we will remand the case for consideration of this point. [Slip op. at 9; footnote omitted.]

We regret the uncertainty which the language of our prior opinion occasioned, and we undertake to clarify it herewith. We did not intend to say, nor infer in any way, that according to respondent's statutory notice its usual presumption of correctness was conclusive as to Pano's receipt of unreported income. As the Court of Appeals held (slip op. at 5), the presumption is simply a procedural device which places the burden of proof on the petitioner to show error by respondent. It is not evidence. Sullivan v. United States, 618 F.2d 1001 (3d Cir.

1980); Rockwell v. Commissioner, 512 F.2d 882 (9th Cir. 1975), affg. T.C. Memo. 1972-133. Pano was thus free to show, by a preponderance of the evidence, Sullivan v. United States, supra, that respondent's determination was erroneous, either in whole or in part. This included his right to show, if he could, either that he received no such income, or that he received less than respondent had determined.

As the Court of Appeals noted (slip op. at 8) Pano's efforts in this regard "consisted of denials that he ever received the income in question." The evidence presented to us was Pano's self-serving testimony that he had not received any of the override commissions that he, both personally and through the employees of his corporations, had aggressively negotiated, and as to which there were several agreements between KLM and one or the other of Pano's wholly-owned corporations in the period in issue.

In discharging our ultimate duty as trier of the facts -- the "distillation of truth from falsehood which is the daily grist of judicial life," Diaz v. Commissioner, 58 T.C. 560, 562 (1972) -- we carefully evaluated the credibility of the witnesses, including Pano, whom we saw and whose demeanor we observed. In making such evaluation, we were not compelled to accept such testimony as gospel, see Gerardo v. Commissioner, 552 F.2d 549, 553 (3d Cir. 1977); Wood v. Commissioner, 338 F.2d 602 (9th Cir. 1964), affg. 41 T.C. 593 (1964). Even when uncontroverted, we may reject such testimony if it is improbable, unreasonable or questionable. Demkowicz v. Commissioner, 551 F.2d 929 (3d Cir. 1977), revg. T.C. Memo. 1975-278; Baird v. Commissioner, 438 F.2d 490, 493 (3d Cir. 1971). Further, as the Court of Appeals herein noted (slip op. at 8), "A general denial of liability is insufficient to meet the taxpayer's burden of nonpersuasion."

We found Pano's testimony lacking in candor and forthrightness, and his memory of events and circumstances to be highly selective. We accordingly rejected his testimony as both improbable and questionable. See Demkowicz v. Commissioner, supra; Baird v. Commissioner, supra. Our failure to say so explicitly is due to the fact that we did not consider Pano's testimony to be uncontroverted in this record. There was ample evidence in this record, through the testimony of KLM employees, Pano's employees and, indeed, Pano himself, that Pano and KLM had met repeatedly and had negotiated agreements for the payment of override commissions during the period here in issue, based upon certain percentages of airline tickets sold by KLM. Although there was no direct evidence as to specific amounts paid by KLM under these override agreements, it was reasonable to conclude, absent any evidence to the contrary, that such agreements, once entered into, were carried out. If they were not, it is difficult to understand why Pano continued to do business with KLM; there is no evidence in this record that he could not have taken his business to another airline which would have been more accommodating. We think that these were reasonable inferences which we could draw from the evidence and which would be contrary to Pano's testimony.

In Sullivan v. United States, supra, the Third Circuit, in commenting upon its earlier case of Demkowicz v. Commissioner, supra, pointed out that where the taxpayer's evidence is not controverted, it might be sufficient to support a finding in his favor unless it is rejected by the trier of fact as being improbable, unreasonable or questionable. However, where the taxpayer's evidence is controverted, Demkowicz does not require that the trial court specifically reject the taxpayer's evidence as improbable, unreasonable or questionable. Where the evidence is in conflict, the trial court can decide the matter on the basis of the usual burden of proof, i.e., whether the taxpayer has proved his case by a preponderance of the evidence. Sullivan v. United States, supra at 1009. Viewed in this light, we concluded that Pano had failed to carry his necessary burden of proof to show, by a prepondernace of the evidence, that he did not receive the income in question. Whether Pano's evidence was to be considered as uncontroverted, or controverted by the other evidence in the record, however, we rejected it as improbable and questionable.

It results that our prior holding in favor of the Commissioner as to the deficiencies in issue must be sustained.

Our prior decision will be reinstated.

323

AUG 28 1986

742-B

Ju 11. 7/2: 1986-401

8

4217

ORIGINAL

T. C. Memo. 1986-401

UNITED STATES TAX COURT

JEAN LOUISE HARNE, Petitioner *v*.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 35598-85. Filed August 26, 1986.

Jean Louise Harne, pro se.

Wilton A. Baker, for the respondent.

MEMORANDUM OPINION

SCOTT, Judge: This case is before the Court on respondent's Motion to Dismiss for Lack of Jurisdiction.

On April 11, 1986, respondent filed a motion to dismiss the above-entitled case for lack of jurisdiction on the ground that the petition was filed more than 90 days after the date of the mailing of the notice of deficiency. On May 15, 1986, petitioner filed a reply to respondent's motion to dismiss in which she in effect admitted that the notice of deficiency had been mailed to her at her proper address at College Park, Maryland, on April 15, 1985, and that the petition had not been filed until September 18, 1985.

Petitioner in her reply argues that the time within which to file her petition should be extended because "the I.R.S." repeatedly asked her not to appeal to the United States Tax Court in April, May, June and July, stating that "it was untimely because the ninety day appeal time did not begin to run until after Petitioner received a letter to be prepared" after re-examination of previous work papers of "the I.R.S." Petitioner stated that she received the letter referred to in late June or early July, 1985. She further stated that she "followed their detailed instructions to mail her appeal to their supervisor in Philadelphia, Penna, whereby, they stated to her that she might still avert the necessity of going into litigation."

On July 18, 1986, petitioner filed Supplemental Objection of Petitioner to Respondent's Motion to Dismiss. In this supplemental objection, petitioner stated that she--

> did miss her proper filing date for this appeal but that it was neither due to her lack of diligence nor promptness, but rather, a direct result of the misrepresentations of the Commission[er] as to the true nature and status of first, the "Notice of Deficiency," second the beginning of the tolling of the ninety day appeal period, and third and finally the steps and entities through and to which the Petitioner's appeal process should have proceeded * * *.

Petitioner states that the misrepresentations are explained in her attached affidavit with exhibits.[1]

Petitioner's affidavit acknowledges that on April 15, 1985, respondent mailed to her a statutory notice of deficiency determining a deficiency in her income tax for the calendar year 1981 of $1,104. In this notice, the following appeared:

> If you want to contest this deficiency in court before making any payment, you have 90 days from the above mailing date of this letter * * * to file a petition with the United States Tax Court for a redetermination of the deficiency. The petition should be filed with the United States Tax Court, 400 Second Street NW., Washington, D.C. 20217, and the copy of this letter should be attached to the petition. The time in which you must file a petition with the Court * * * is fixed by law and the Court cannot consider your case if your petition is filed late. * * *

---

[1] In her response to respondent's motion to dismiss, petitioner asked for a hearing to enable her to establish the facts she had recited. After a review of petitioner's affidavit and the documents attached thereto, we see no reason for setting respondent's motion for hearing. In our opinion, accepting all factual statements made by petitioner as true, respondent's motion must be granted.

The notice of deficiency further states: "If you have questions about this letter, please write to the person whose name and address are shown on this letter." The name appearing at the top of the letter under the designation "Person to Contact" is D. Gibson, and a telephone number is given.

Petitioner states that she called a Ms. Thompson who had been handling her case before the deficiency notice had been issued. Petitioner noticed the statement in the deficiency notice about appealing within "90 or 150 days as the case may be." She asked Ms. Thompson about this statement and "was given to understand that the matter was in the nature of a non-final judgment until the review had taken place and that there was room for time until a 'letter' was received stating the results of the review * * *." Petitioner states she made an appointment with Ms. Thompson to present certain documents for her review. On June 25, 1985, petitioner received a letter dated June 19, 1985, informing her of the results of her conference with Ms. Thompson. The letter informed petitioner that two copies of a report supplementing the statutory notice of deficiency were enclosed and that if she cared to agree to the results of this report she should sign and return the agreement form enclosed. The last two paragraphs of this letter state:

> If you do not accept, you may, within the period stated in the statutory notice petition the United States Tax Court for a redetermination of your tax liability.

> This correspondence and consideration of your case has not extended the period in which you may file a petition with the United States Tax Court. If no petition is filed within the allotted time, we will assess the tax and bill you.

At the bottom of this letter below the signature of the District Director the following appeared:

> Note: Per our conference on 6/19/85, please find enclosed copies of the auditor's workpapers. Your case has been returned to our Baltimore office, 90 Day Section, attention Mr. Gibson.

On June 25, 1985, petitioner addressed a letter to the District Director, Internal Revenue Service, Baltimore, Maryland, attention of the Appeals Division, in which she stated that she was making an appeal to the findings of the local office "of I.R.S. in Suitland, Maryland, per their letter that I received today, June 25, 1985. * * * Ms. Thompson informed me that I could appeal and that I should wait for her letter." The letter further stated that petitioner was appealing the same day she received the letter dated June 19, 1985, to which Ms. Thompson had referred.

The balance of the correspondence attached to petitioner's affidavit shows that the deficiency as determined, plus interest and "penalty," was assessed against petitioner and that a notice and demand for the amount of the assessment was mailed to her. The total amount stated as due, including interest and "penalty," was $1,749.08. The final document shows that on petitioner's return for the calendar year 1985, she claimed an overpayment of $5,026.03, and that by letter dated March 17, 1986, she was informed that $1,749.08 of this claimed overpayment had been applied to the tax still due by her for the calendar year 1981 and she was being refunded $3,276.95.

The record here is clear that respondent issued a proper notice of deficiency to petitioner and she did not file her petition with this Court in 90 days from the date of the issuance of the notice. Therefore, unless some action by representatives of respondent amounted to a withdrawal of this notice, we lack jurisdiction to hear this case because of the untimely filing of the petition.

Section 6213(a)[2] confers jurisdiction on this Court to hear cases when a timely petition is filed. This Court's jurisdiction is statutory and therefore, unless the petition is timely filed, the Court has no jurisdiction to consider the case. Estate of Moffat v. Commissioner, 46 T.C. 499, 501 (1966).

After a notice of deficiency is issued to a taxpayer and prior to a petition being filed in this Court, some cases suggest that the notice may be withdrawn. See Skaneateles

---

[2] Unless otherwise stated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the year here in issue.

Paper Co. v. Commissioner, 29 B.T.A. 150, 155 (1933).[3] If petitioner could show some action by respondent that amounted to a withdrawal of the deficiency notice, we would have to dismiss the case on the ground that no determination of deficiency had been made by respondent from which an appeal could be taken. However, the effect of such a dismissal would differ from a dismissal for lack of jurisdiction on the ground that no timely petition was filed from a proper notice of deficiency. See Keeton v. Commissioner, 74 T.C. 377, 379 (1980).

Accepting the facts as stated in petitioner's affidavit, it is clear that the notice of deficiency mailed April 15, 1985, was not withdrawn. In the notice of deficiency petitioner was informed that an appeal to this Court must be filed within 90 days from the date of the deficiency notice. She had conferences with someone in the Internal Revenue Service, attempting to dispose of the issues raised in the deficiency notice by agreement prior to the expiration of the 90-day period. However, a letter from respondent's representative dated June 19, 1985, which petitioner received on June 25, 1985, 20 days before the expiration of the 90-day period for filing a petition with this Court, specifically informed petitioner that the correspondence and consideration given to her case after the mailing of the notice of deficiency did not extend the period within which she might file a petition with this Court.

---

[3] See also Holter v. Commissioner, T.C. Memo. 1978-411.

The fact that petitioner understood some employee of the Internal Revenue Service to tell her to send her appeal to the District Director in Philadelphia rather than to this Court is certainly not tantamount to a withdrawal of the notice of deficiency. Written notice was given to petitioner in the notice of deficiency and the letter of June 19, 1985, to file a petition with this Court if she wished to contest the deficiency as determined. Clearly, on this record there was no withdrawal of the notice of deficiency. This Court lacks jurisdiction to hear this case since the petition was not filed within the 90-day period from the date of the mailing of the notice. Therefore, respondent's Motion to Dismiss for Lack of Jurisdiction will be granted.

Although we have disposed of the issue in this case, we point out for petitioner's benefit that because this Court did not obtain jurisdiction of her case, she is entitled to file a claim for refund of the taxes, interest, and additions to taxes paid by an offset against her claimed overpayment for the calendar year 1985. When her claim has been filed, respondent will have the authority to consider any evidence she has to present tending to show error in her tax liability as determined by respondent in the notice of deficiency.

An appropriate order will be entered.

323 742-B Ju 11.7/2:1986-402

#217

4

ORIGINAL

T. C. Memo. 1986-402

UNITED STATES TAX COURT

MIRIAM T. McGILL, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 34668-84. Filed August 26, 1986.

Miriam T. McGill, pro se.

Steven K. Dick, for the respondent.

MEMORANDUM OPINION

RAUM, Judge: The Commissioner determined deficiencies[1] in petitioner's income tax and additions to tax for the calendar years 1978-1982, as follows:

---

[1] The deficiency notice recognized that there were credits for withholding in the amounts of $143.18, $185.62, $186.18, $270.02, and $320.72, for the years 1978-1982, respectively. Such credits should be taken into account in the course of collection of the deficiencies, which are sustained infra in this opinion.

		Additions to Tax, I.R.C. Section			
Year	Deficiency	6651(a)(1)	6653(a)(1)	6653(a)(2)	6654(a)
1978	$ 402.00	$ 64.71	$ 20.10	$0.00	$ 7.12
1979	634.00	112.10	31.70	0.00	16.82
1980	773.00	146.71	38.65	0.00	34.48
1981	1,138.44	217.11	56.92	50% of the interest due on $1,138.44	61.55
1982	876.00	138.82	43.80	50% of the interest due on $876.00	46.23

The case was submitted on the basis of a stipulation of facts which, together with exhibits, is incorporated herein by reference.

Petitioner, a resident of South Bend, Indiana, when the petition herein was filed, worked for Wayne Hardware Co., Inc., during the tax years. She did not file any income tax returns for any of those years. She earned wages from her employer in the amounts of $5,444.80, $6,859.70, $7,632, $8,256, and $8,784 during the years 1978 through 1982, respectively. These amounts appear in the forms W-2 prepared by Wayne Hardware Co., Inc.

The Commissioner also determined that she received "other compensation" in the amount of $908 from her employer in 1981 in addition to the foregoing wages. The record does not establish that there was any error in that determination. Petitioner concedes that she received $300 interest income in each of the five years in issue from Southern Bell Telephone and Telegraph Co.

Petitioner's principal contention is that she received no income in respect of her wages or compensation because she merely exchanged her labor for such wages or compensation and realized no gain in such exchange of "property". The same argument has been made in a number of other cases and uniformly rejected as frivolous. It is utterly without merit and does not warrant any further consideration or even the mere citation of supporting authority.

In the petition it is alleged that the "Commissioner errored in determining Petitioner not entitled to standard deductions of Schedule A and B forms during the years in question". To the extent that petitioner was referring to the "standard deduction" or the "zero bracket amount", she is in error because those amounts are factored into the tax tables from which the tax is determined. To the extent that this allegation was intended to refer to specific deductions there is no support in the record for her position.

To be sure, the record does contain materials that would support a contention that petitioner had certain small medical expenses, some small deductions for charitable contributions, and some possible theft losses in two of the years. However, the record completely fails to establish the amounts of such theft losses, particularly petitioner's basis in any of the alleged stolen items that she had received by gift or inheritance. Moreover, there is utterly no proof that the aggregate of all the possible deductions exceeded the standard deduction or the zero bracket amount in any of the years at issue. We can find no error in the Commissioner's determination in this respect.

As to the additions to tax, petitioner has not shown any one of them to be in error.

Decision will be entered for the respondent.

3 2 3

AUG 29 1986

74273 JU 11.7/2:1986-403

COMPLETED

40

ORIGINAL

4214

T. C. Memo. 1986-403

UNITED STATES TAX COURT

BURTON L. SPELLMAN and ROSLYN SPELLMAN, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24826-84. Filed August 27, 1986.

Allen B. Glass, for the petitioners.

J. Anthony Hoefer, for the respondent.

MEMORANDUM OPINION

KORNER, *Judge*: This matter is before the Court on respondent's motion for partial summary judgment pursuant to the provisions of Rule 121.[1] The issue raised by the motion is whether Elmer South Oil Partnership, Ltd., an Oklahoma limited

---

[1] All Rule references are to the Tax Court Rules of Practice and Procedure.

C. M. / VL

partnership, is entitled to a deduction for research and experimental expenditures under section 174.[2]

Respondent determined a deficiency in Federal income tax against petitioners in the amount of $3,913 for their taxable year ended December 31, 1980.

Burton L. Spellman ("Burton" or "petitioner") and Roslyn Spellman ("Roslyn") were husband and wife and residents of Morton Grove, Illinois, at the time the petition herein was filed. Burton and Roslyn (hereinafter referred to, collectively, as "petitioners") filed a joint Federal income tax return for their taxable year 1980, using the cash receipts and disbursements method of accounting. During the year in issue Burton was an executive and Roslyn was a housewife.

Elmer South Oil Partnership, Ltd. ("Elmer South") was organized as a limited partnership under the Oklahoma Uniform Limited Partnership Act on July 25, 1980. Elmer South's general partner was T. X. Investment Corp.; its limited partner was Charles Kaplan.

Sometime prior to December 22, 1980, and pursuant to the provisions of an amended partnership agreement, Elmer South was reorganized and expanded for the stated purposes of: (1) Investing in certain oil and gas drilling and development ventures; and (2) investing *as a limited partner* in Sci-Med, an

---

[2] All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, except as otherwise noted.

Israeli limited partnership to be formed for the purposes of engaging in the research, development, and exploitation of beta-lactam antibiotics,[3] and entering into a licensing agreement for purposes of marketing and distributing the beta-lactam antibiotics "if developed." Elmer South was to exist until January 2, 2010, unless extended or earlier terminated as provided in the amended limited partnership agreement.

Yuki, Inc. ("Yuki") became the general partner of Elmer South in the reorganization. Yuki was an Oklahoma corporation organized to serve as the general partner of Elmer South. The stockholders of Yuki were Zalmon Horn and Alex J. Pinsky. Yuki had no prior experience in the development and drilling of oil or in the acquisition of inventions and the explcitation of technology. Prior to the formation of Yuki, Horn and Pinsky had structured offerings of investments in real estate, and of research and development and oil and gas ventures. They had substantial experience in the review and analysis of tax sheltered investments.

Yuki was required, as general partner, to contribute $1,000 to the capital of Elmer South, in exchange for which it would receive a 1 percent interest in the partnership. The amended partnership agreement provided that the general partner was to have the sole and exclusive power to manage and control all aspects of Elmer South's business affairs. In consideration for its services as general partner, Yuki was to receive management fees, organization costs, and additional management fees.

---

[3] Penicillin and cephalosporin-type antibiotics.

The amended partnership agreement further provided that Elmer South was to have 35 limited partners. The limited partners were not to take part in any aspect of the management or to transact any business of the partnership. They were to have no power to sign for or to act for the partnership. Each limited partner was to irrevocably appoint the general partner as his true and lawful attorney and agent for purposes of executing, acknowledging, swearing to, and filing all documents which the general partner determined to be necessary to discharge the purposes of the partnership.

Annual net profits or losses from the investment in Sci-Med, tax credits, and nonliquidating distributions were to be allocated 99 percent to the limited partners of Elmer South, and 1 percent to Yuki as general partner.

In December 1980, Yuki offered 35 limited partnership units in Elmer South to prospective investors at a price of $16,500 each, payable in three installments as follows: (1) $11,000 upon execution of the subscription agreement; and (2) a promissory, "subscription" note in the principal amount of $5,500 payable in two interest-free installments of $2,750 each on or before November 1, 1981, and November 1, 1982. Each limited partnership unit represented an interest of 2.85714 percent.

Elmer South and Ikapharm, an Israeli corporation, entered into a partnership agreement dated December 16, 1980, pursuant to the terms of which they formed Sci-Med, an Israeli limited partnership, for the purpose of engaging in the research, development, manufacture, and marketing of new beta-lactames. Ikapharm, Israel's second largest pharmaceutical manufacturer, was Sci-Med's general partner. Elmer South was Sci-Med's limited partner. As general partner of Sci-Med, Ikapharm was granted the exclusive right to manage and control the partnership's business. Ikapharm was obligated, inter alia, to see to the diligent fulfillment of a sub-research and development agreement to be entered into by Sci-Med and Teva Pharmaceutical Industries, Ltd. ("Teva"), Israel's largest pharmaceutical group and the parent of Ikapharm, with Teva as the active party under the contract. As the limited partner, Elmer South was not to participate in the management or to transact any business of Sci-Med. Elmer South could not act for or bind Sci-Med. Ikapharm contributed $1 to the capital of Sci-Med. Elmer South was to contribute to Sci-Med amounts not to exceed $855,000; contributions, however, were not to exceed $50,000 for 1981 and $42,500 for 1982. All items of income, deduction, net gain, or loss from the Sci-Med partnership were to be allocated to Elmer South, except for 1 percent of the gross royalty income, not to exceed $10,000, which was to be allocated to Ikapharm.

The fiscal year of Sci-Med was a calendar year and its books and records were to be kept using the accrual method of accounting. Sci-Med was to exist for a period of 95 years from December 16, 1980, unless earlier terminated as provided in the partnership agreement.

On or after December 16, 1980, Teva entered into an agreement with the government of Israel, pursuant to the terms of which Teva was to conduct research and development for the general purpose of developing new antibiotic drugs, including the synthesis of new drugs as well as the extension of any drugs currently in existence. With respect to the research, Teva was to report directly to the Israeli government.

The government of Israel, through its Industrial Development Bank ("IDB"), was to loan an amount equal to 50 percent of the research expenses, estimated by Teva to be $855,000, to the limited partners of Elmer South, through Teva. The research was to be carried out within 36 months of the approval of the loan. The research was to be monitored by the Israeli government through a variety of interim financial reports, including reports at the end of the 36-month research period. Teva had 7 years, unless extended, within which to exploit any products developed under the research and development agreement. Rights to any products not exploited by Teva were to be transferred to the Israeli government. Should the Israeli government undertake to exploit any such products, the proceeds therefrom were to be applied: (a) To repay the loan from the government of Israel to the limited partners of Elmer South; and (b) any remaining amounts were to be divided equally between Teva and the Israeli government.

On December 16, 1980, Sci-Med and Teva entered into a sub-research and development agreement pursuant to the terms of which Teva agreed to undertake a research and development program in the general area of development of new antibiotic drugs, including "the synthesis of new drugs as well as the extension of any drugs currently in existence." The specific research area was the rational extension of beta-lactam antibiotics, a concept having as one of its originators an independent consultant to Teva. Teva's research was to address the therapeutic problem presented by the effect of stronger beta-lactam antibiotics -- necessary because of the evolution of various mutant strains of bacteria resistant to known beta-lactam antibiotics -- on portions of the body unrelated to the bacteria which they were meant to attack. Since it has been proved that penicillin in some way interferes with the enzymes that act to complete the wall of the bacterial cell, Teva intended, by the rational extension of the beta-lactam antibiotics, to create an antibiotic more resistant to detoxification by the bacteria. The research was to include, but was not limited to, the various steps necessary to develop a natural, semi-synthetic, or synthetic molecule that would interfere or in some other way act to control or affect the catalytic or regulatory process with respect to the completion of the bacterial cell wall. Teva irrevocably assigned, conveyed, and transferred all of its right, title, and interest in and under the research and development agreement with the Israeli government and to any program payments to Sci-Med.

During the term of the sub-research and development agreement, Teva was to perform the required services in an effort to develop products[4/] to be sold in commercial quantities for both medical and nonmedical uses. The sub-research and development agreement also provided that, should the specific project prove not to be "economically justifiable, the Developer [Teva] and the General Partner [Yuki] of the U.S. Partnership [Elmer South] shall mutually agree to amend the R&D [research and development] Program so as to substitute and undertake other specific projects * * *." Elmer South's interest in the substituted research project was to be in such proportion as Elmer South's remaining funds bore to the total sum required to complete such new research project.

[4/] Products was defined as including:

> any inventory or patents (wherever applied for or granted) those related to the area being developed in the research and development program or relating to the specific project described in Appendix 3 [the rational extension of Beta-lactam antibiotics] pursuant to the research and development program. The products which is [sic] developed herein shall include both patentable and nonpatentable inventions. It shall not however include any inventions, technical information or other technology which is being developed in another specific area within the general area of the "development of antibiotic drugs."

The sub-research and development agreement provided that, in consideration for its services, Teva was to receive a total of $855,000, payable as follows: $5,000 upon execution of the agreement; $14,000 within 14 days of the execution of the agreement; and the balance within 14 days after the receipt of vouchers for expenses approved by the Israeli government. Not more than $50,000 were, however, to be paid in any calendar year. Sci-Med was to satisfy its obligation to Teva by paying $427,000 plus all of the proceeds, in shekels,[5] irrespective of dollar value, of the loan from the government of Israel.

Contemporaneously with the execution of the sub-research and development agreement, Sci-Med and Teva entered into an exclusive license agreement dated December 16, 1980. The agreement provided that Teva wanted to obtain "the sole and exclusive license to make and manufacture[6] and to use, sell and otherwise distribute Products[7] throughout the world and in connection therewith to use the "Proprietary Information,"[8] and granted

---

[5] The shekel replaced the Israeli pound as Israel's monetary unit on February 23, 1980.

[6] Manufacture of products outside of Israel was not permitted without prior written consent of the government of Israel, represented by the OCS.

[7] See n. 4, supra.

[8] Proprietary information was defined as:

> any and all inventions, patent applications and patents (wherever applied for or granted) trade secrets, technical information (including all blueprints, plans, drawings and specifications) and

(footnote continued)

Teva the exclusive license "to manufacture and make sales or other dispositions through the world of Products." Teva was further granted the right to sublicense the license, and "to use in its entirety the Proprietary Information." Sci-Med agreed to refrain from, directly or indirectly, manufacturing, selling, or distributing products, under its own brand name or on behalf of others, which may reasonably be regarded by Teva as directly competitive with the products. Sci-Med was obligated to provide reasonable security measures to prevent unauthorized persons, including an affiliate of Sci-Med, from obtaining any information, notes, records, data, plans, designs, or other documents constituting proprietary information. Sci-Med further agreed not to divulge such knowledge and not to permit any of its affiliates to perform any function or job in connection with products or to have access to the proprietary information unless such person entered into a nondisclosure agreement containing restrictions similar to those applicable to Sci-Med.

(footnote continued from previous page)

> other technology relating to Products and developed in the R&D [research and development] program or related to Products and developed following completion of the R&D program and during the term of this Agreement. The Proprietary Information shall not include any technical information or other technology which is not patented or patentable by the Licensor [Sci-Med] (or the Licensee hereunder [Teva] on behalf of the Licensor [Sci-Med]) and which is described in any prior printed publication or is publicly known in the industry in which the Licensee [Teva] is engaged.

Under the provisions of the exclusive license agreement, Teva was to pay to: (1) Sci-Med a royalty of 5 percent of the net sales and of the sublicensing fees until Sci-Med had recouped its research expenses. Thereafter, Teva was to pay Sci-Med a royalty of 1 percent of net sales and of the licensing fees; and (2) a special fund in care of the Office of the Chief Scientist ("OCS") of the Israeli government any commission which Sci-Med was or might be required to pay.[9] Teva was to institute and prosecute any patent-infringement or other suits necessary to protect Sci-Med's and Teva's respective rights, title, and interest in and to any patents and trade secrets or other confidential information included within the proprietary information. Teva was to permit access to the premises where the business pursuant to the exclusive license agreement was conducted to the authorized representative of "the General Partner of the Licensor" [Ikapharm] and/or of the OCS during normal business hours "for the purposes [sic] of monitoring the progress of such business."

The term of the exclusive license agreement was to expire 95 years after the date of receipt by Sci-Med of the first royalty payment, except that the agreement would automatically terminate if the government of Israel obtained Sci-Med's rights to patents on the inventions resulting from the research and development program. The agreement further provided for its early termination under the following circumstances: (1) Upon or after the filing by either Sci-Med or Teva of a petition in bankruptcy, reorganization, liquidation, or insolvency or upon an adjudication thereof; (2) upon assignment of all or any portion of the agreement or of the license granted therein by Teva in violation of its provisions; (3) upon any fundamental default or breach of the terms of the agreement by the other party not cured within 90 days of notice thereof. Upon expiration of the term of the agreement, or if earlier duly terminated by Teva, Teva was to become the owner of all the rights, title, and interest in and to the proprietary information. Teva was to have no further obligation under the exclusive license agreement other than: (1) To make payments of royalties and to supply statements relating thereto to Sci-Med; and (2) to make all commission payments to which the OCS was entitled with respect to the sale or other disposition of products.[10]

---

[9] The beneficiary of this fund is not disclosed in this record.

Teva and Sci-Med executed an option agreement on December 16, 1980, pursuant to the terms of which Sci-Med granted Teva an irrevocable option "to purchase all of Licensor's [Sci-Med's] rights, title and interest in the 'Proprietary Information.'"[11] The option was exercisable at any time after June 30, 1982, by giving Sci-Med written notice of the intent to exercise the option accompanied by a nonrefundable downpayment of

---

[10] See n. 4, supra.

[11] See n. 8, supra.

$2,000, and an additional $18,000 payable concurrently with the next $18,000 payable to Sci-Med with respect to net sales and license fees. The consideration to be paid by Teva for the exercise of the option was Teva's "understanding to honor all its warranties, representations, covenants and undertakings set forth in the Exclusive License Agreement (including but not limited to the payments described in Paragraph 5 of the Exclusive License Agreement)" for a period coterminous with the term of the exclusive license agreement.[12] Upon exercise of the option, Teva was to have all of the rights appertaining to the proprietary information, including the right to apply for and register all related patents in its name.

A handwritten addendum to the aforesaid agreements provided that, notwithstanding any provisions to the contrary contained in the agreements, the term of the exclusive license agreement and of the option agreement and of Sci-Med's life was to be the later of: (1) 24 years from December 16, 1980; or (2) 15 years from the date of commercial exploitation of the product. In no event, however, were the said terms to extend beyond the year 2019.

---

[12] The payments described in the said paragraph 5 of the exclusive license agreement included, inter alia, the royalty payments on net sales and license fees.

The sub-research and development agreement, the exclusive license agreement, the option agreement, and the written addendum were executed by Dan Suesskind on behalf of both Sci-Med and Teva. Suesskind was an officer of both Teva and Ikapharm, Teva's subsidiary and Sci-Med's general partner.

On December 31, 1980, petitioner subscribed to 50 percent of a limited partnership unit, representing a 1.42857 percent interest in Elmer South. Petitioner paid $5,500 in cash as part of his required capital contribution. The promissory "subscription" note was in the principal amount of $2,750, payable in two interest-free installments of $1,375 each on November 1, 1981, and November 1, 1982. The assignment of production payment and agreement provided for the assignment of the said payments to Teva as collateral for the assumption indebtedness under the sub-research and development agreements. Pursuant to the assumption indebtedness, petitioner agreed to pay to Teva, upon receipt of 30-day written notice, 1.42857 percent of the unpaid portion of the amounts due to Teva under the sub-research and development agreement, but not to exceed $11,500.

In 1981, the IDB and Elmer South, represented by its general partner Yuki, entered into a loan agreement under the terms of which IDB agreed to lend to Elmer South's limited partners, represented by Yuki, the aggregate principal amount of 720,320 Israeli shekels payable in installments or advances beginning 2 months from the date of commencement of the research and development project and thereafter as progress reports were submitted by the OCS. The aggregate of the advances was not to exceed the equivalent of $150,000. The terms of the loan called for repayment of principal and interest, at an annual rate of 6 percent on the outstanding principal amount, payable in shekels or dollars at Yuki's discretion, 12 years from the first advance. Interest was not to accrue until the research and development program was completed as determined by the OCS. Yuki, as nominee of the limited partners of Elmer South, had the option of extending the term of the loan for an additional 12-year term by giving written notice to the IDB and to the government of Israel before the expiration of the original 12-year period. Elmer South's "net profit," as therein defined, from Sci-Med for the preceding calendar year was to be determined on each payment date and 25 percent thereof was to be applied towards reduction of the outstanding principal and interest on the loan.

Elmer South reported an ordinary loss of $1,148,776 on its U.S. Partnership Return of Income, Form 1065, for its taxable year ended December 31, 1980. The said loss included a claimed deduction in the amount of $855,000 for research and experimental expenditures attributable to the Sci-Med venture. Elmer South's return was filed on a calendar year basis, using the accrual method of accounting.

Petitioners claimed a loss of $16,243, representing their distributive share of the losses claimed by Elmer South, on their Federal income tax return, Form 1040, for their taxable year ended December 31, 1980.

In his notice of deficiency dated April 12, 1984, respondent adjusted the amount of the loss claimed by petitioners to reflect, inter alia, the disallowance of the research and development expenses in the amount of $855,000 claimed by Elmer South, on the grounds that petitioners had failed to establish:

> (a) That the amounts were paid or incurred; (b) that the amounts were paid or incurred for the purposes indicated; (c) that the amounts paid or incurred were ordinary and necessary business expenses; (d) that the amounts were not nondeductible preoperating and/or capital expenditures; (e) that the alleged transactions, expenditures, and events underlying the claimed deductions ever occurred in fact or substance; (f) that the alleged transactions, expenditures, and events underlying the claimed deductions served any business purpose or possessed any economic substance and, hence, were not mere shams for federal income tax purposes; (g) that the alleged venture was entered into and carried on as a trade or business, or for the production and/or collection of income; (h) that the alleged venture was entered into and carried on for profit; (i) that any amount in excess of the cash you actually contributed under the terms of your subscription agreement should be includable in either the partnership's or your adjusted basis for the activity and/or its underlying assets; (j) that you were "at risk" under I.R.C. §465 for any amounts in excess to the cash you actually contributed under the terms of your subscription agreement; (k) that any alleged contractual payment arrangement entered into by you has economic substance, represents a bona fide debt obligation, is not contingent and indefinite in nature, has a business purpose, does not cause a material distortion of income, and meets the "all events" test; and (l) Additionally, with regard to the research and

> development deduction, that the amount deducted was actually paid or incurred for new product research and development.

Petitioners filed a petition with this Court on July 12, 1984.

On October 28, 1985, respondent filed a motion for partial summary judgment herein, together with documents supported by affidavit. Said motion was calendared for hearing at Chicago, Illinois, on November 12, 1985. On that date, respondent filed a memorandum brief in support of his motion for partial summary judgment.

On December 30, 1985, petitioners filed a memorandum brief in opposition to respondent's motion for partial summary judgment, together with supporting affidavit and document. Respondent moved for leave to file a reply to petitioners' memorandum brief on January 21, 1986, which leave was granted on January 27, 1986. Respondent filed his reply brief on March 12, 1986.

The case is before us in this position.

Rule 121(b) provides that a decision may be rendered on a motion for summary judgment if it is shown "that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. A partial summary adjudication may be made which does not dispose of all the issues in the case."

Rule 121 is derived in large part from Rule 56 of the Federal Rules of Civil Procedure. See notes to the Court's new rules of 1974, 60 T.C. 1057, 1126-1129.

The party moving for summary judgment has the burden of proving that no genuine issue as to any material *fact* exists, and that he is entitled to judgment as a matter of law. *Adickes v. Kress & Co.*, 398 U.S. 144, 157 (1970); *Gulfstream Land and Development v. Commissioner*, 71 T.C. 587, 596 (1979). The factual materials presented and the inferences to be drawn from such materials must be viewed in the light most favorable to the party opposing the motion so that any doubt as to the existence of a genuine issue of material fact will be resolved in favor of denying the motion. *Adickes v. Kress & Co.*, 398 U.S. at 157; *Jacklin v. Commissioner*, 79 T.C. 340, 344 (1982). The motion must be granted if the Court is satisfied that no real factual controversy is present so that the remedy can serve its "salutary purpose in avoiding a useless, expensive and time consuming trial where there is no genuine material fact issue to be tried." *Lyons v. Board of Education of Charleston*, 523 F.2d 340, 347 (8th Cir. 1975). Nevertheless, a motion for summary judgment may not be defeated by the mere allegation that there is a dispute over a material fact; the adverse party must set forth, by affidavit or otherwise, specific facts showing that there is a genuine factual issue for trial. Rule 121(d).

Respondent's motion for partial summary judgment is addressed only to Elmer South's claimed deduction for research and experimental expenditures. In support of his motion, respondent relies on certain documentary evidence and admitted allegations in the pleadings. For purposes of this motion only, he accepts the assertions contained in such documents as true.

Section 174(a)(1) provides, as a general rule, that research or experimental expenditures which are paid or incurred by a taxpayer during the taxable year in connection with his trade or business may, at the election of the taxpayer, be treated as expenses not chargeable to capital account and may be, therefore, deducted in the taxable year. The expenditures to which section 174 apply may relate to a general research program or to a particular project. Sec. 1.174-1, Income Tax Regs. The provisions of section 174 "apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor)." Sec. 1.174-2(a)(2), Income Tax Regs.

Prior to the Supreme Court's decision in Snow v. Commissioner, 416 U.S. 500 (1974), this Court had taken the position that, in order to be deductible under the provisions of section 174(a)(1), research or experimental expenditures had to be made in connection with an existing trade or business to which such research or experimentation was proximately related, and not with a mere prospective business. Best Universal Lock Co. v. Commissioner, 45 T.C. 1, 10 (1965); Koons v. Commissioner, 35 T.C. 1092, 1100 (1961). Research or experimental expenditures incurred by a taxpayer not currently engaged in a trade or business to which the expenditures were proximately related were held to be nondeductible pre-operating expenses. Koons v. Commissioner, 35 T.C. at 1101.

In Snow v. Commissioner, 416 U.S. 500 (1974), revg. 482 F.2d 1029 (6th Cir. 1973), which affirmed 58 T.C. 585 (1972), the taxpayer, an executive in a large corporation, contributed $10,000 for a 4-percent interest in Burns Investment Company, a limited partnership formed in 1966 to develop "a special purpose incinerator for the consumer and industrial markets." Trott, the general partner of the partnership, was the inventor of the incinerator and had conceived this idea in 1964. Between 1964 and 1966, Trott made and tried out a number of prototypes. In 1965, his patent counsel advised him that the incinerator as a whole had not been sufficiently "reduced to practice" in order to develop it into a marketable product. At that point Trott formed Burns, taxpayer putting up part of the capital. Trott conveyed all his rights in the invention to the partnership. During 1966, Burns had no manufacturing plant or office. No effort was made to market or sell the device in 1966. After 1966, the design of the incinerator was changed in some particulars. An application for a patent was filed in 1968 and granted in 1970. Prior to 1970, Burns was incorporated and was producing and marketing the incinerator, the taxpayer being its chairman of the board of directors.

The taxpayer was also a limited partner in two other limited partnerships formed by Trott, who was also their general partner, for the respective purposes of developing a telephone-answering device and an electronic tape recorder. Both partnerships had claimed deductions for research or experimental expenditures in 1965 and 1966 which were not challenged by the Commissioner, apparently because their products were in a more advanced stage of development and were available for sale or licensing.

This Court held that the taxpayer was not entitled to deduct his distributive share of Burns' claimed research or experimental expenditures in 1966, since the partnership was not engaged in a trade or business and the research was not related to Burns' or the taxpayer's own trade or business. 58 T.C. at 597. The Sixth Circuit affirmed our conclusion that the partnership's expenditures were pre-operating expenses and therefore nondeductible under section 174. 482 F.2d at 1032.

The Supreme Court reversed and stated that section 174 was enacted to "dilute some of the conception of 'ordinary and necessary' business expenses under section 162(a)" adumbrated by Justice Frankfurter in a concurring opinion in Deputy v. duPont, 308 U.S. 488 (1940) -- where he said that carrying on a trade or business, for purposes of the predecessor of section 162, "involves holding one's self out to others as engaged in the selling of goods or services." 308 U.S. at 499. The phrase "trade or business" contained in approximately 60 sections of the Code was, the Supreme Court noted, not helpful in interpreting the phrase "in connection with" in section 174(a)(1) since section 162(a) is more narrowly written than is section 174. The deduction for the taxpayer's distributive share of the research and expenditures was allowed for 1966, even though there were no sales in that year, since to do otherwise would "defeat the congressional purpose somewhat to equalize the tax benefits of the ongoing companies and those that are upcoming and about to reach the market * * *." 416 U.S. at 504. Cleveland v. Commissioner, 297 F.2d 169 (4th Cir. 1961), was cited with approval.

In Cleveland v. Commissioner, supra, the investor-taxpayer advanced monies, beginning in 1931, to an inventor for support of his family and for materials and equipment to enable him to carry on his work. The taxpayer, an attorney, provided advice to the inventor, negotiated transfers to users of the inventions, and prepared any necessary legal documents. The taxpayer made the inventor acquainted with those persons known to him who were or might be engaged in such fields of endeavor as would provide the necessary outlets for the invention. By at least 1945 the two men had orally agreed that they had equal interests in the enterprise. On April 20, 1956, a "trust" document was executed, retroactive to December 31, 1954, recording the tenor of their mutual understanding.

The Fourth Circuit upheld this Court's determination that the taxpayer's advances to the inventor prior to the execution of the written agreement were loans and therefore not deductible as research and experimental expenditures under section 174. It also held that the advances, other than advances for the personal expenses of the inventor, made after the date of execution of the agreement -- providing that: (1) The inventor was to devote "his full time in active experimentation on the invention;" (2) the taxpayer was to advance the expenses of experimentation of the inventor to the extent of his financial ability to do so; (3) should the invention be financially successful the taxpayer's law firm would be compensated for the legal services provided by the taxpayer; and (4) they would equally share the avails thereof -- were deductible under section 174. The Court of Appeals found that on the day of and after the execution of the agreement, the taxpayer was "engaging with the inventor in the trade or business of promoting the commercial development of the invention of which [the taxpayer] was the owner of a participating one-half interest." 297 F.2d at 173-174.

This Court was again faced with the issue of the deductibility of claimed research and experimental expenditures in Green v. Commissioner, 83 T.C. 667 (1984). This case involved a limited partnership, LaSala Ltd., originally formed in 1977 and reorganized and expanded in 1979 for the stated purpose of acquiring four inventions for investment and income producing purposes and to thereafter patent, improve, maintain, and exploit the inventions. LaSala entered into four sets of agreements -- each set concerning one of the four inventions acquired by the partnership -- each set including: (1) An acquisition agreement; (2) a research and development agreement; and (3) an exclusive license agreement. Each acquisition agreement was entered into between LaSala and an inventor and, by its terms, conveyed all of the inventor's right, title, and interest in his invention or inventions, including any patent rights, to the partnership. None of the four inventions acquired by LaSala was patented as of December 24, 1979. LaSala entered into four research and development agreements with NPDC, a patent development company, pursuant to the terms of which NPDC agreed to provide research and experimental services, systems analysis, and technical documentation "as are reasonably necessary and customary to develop the Product into a commercially viable, marketable product or process." NPDC further agreed to furnish LaSala with quarterly progress reports of functions performed, changes in personnel or subcontractors, and funds expended, and agreed to confer with representatives of LaSala to explain such progress reports. Also on the same date, LaSala and NPDC entered into four identical exclusive license agreements pursuant to which LaSala granted NPDC the "exclusive worldwide right and license to enjoy, commercialize, manufacture, use, sell and exploit the Products."[13] The license agreements provided that the patents were to remain the exclusive property of LaSala. NPDC was obligated to make annual royalty payments to LaSala. Taxpayer-husband became a limited partner in LaSala. Taxpayers claimed a loss, representing their distributive share of the losses claimed by LaSala -- including a deduction for research and experimental expenses -- which was disallowed by the Commissioner. This Court granted the Commissioner's motion for partial summary judgment, addressed to LaSala's claimed deductions for depreciation and research or experimental expenses, and held, inter alia, that: (1) The grant by LaSala of the exclusive right to manufacture, use, and sell the inventions for the duration of the patents conveyed to NPDC all of its substantial rights in the four inventions; and (2) LaSala's expenditures under the research and development agreements were not "in connection with" any trade or business as required by section 174.

---

[13] Including: (1) The right to grant sublicenses on such terms that were not violative of the provisions of the license agreement; (2) all inventions, improvements, patent applications, or patents then or thereafter owned or controlled by LaSala; and (3) the furnishing to NPDC with the necessary blueprints, working drawings, and all other data and information necessary for the manufacture of the product to the extent available or received by LaSala from the creator of the product or the developer.

Respondent argues that, since Sci-Med transferred its proprietary interest and substantial rights in the results of the research and development venture to Teva, Sci-Med was precluded from ever having an active, substantial interest in the results of the research and development and from using the results in connection with any trade or business. Therefore, the argument follows, the research and experimental expenditures were not "in connection with [Sci-Med's] trade or business" within the meaning of section 174. Respondent relies on Green v. Commissioner, supra. Additionally, he asserts that the claimed research or experimental expenditures were not incurred in Sci-Med's behalf because Teva was the substantive beneficiary of the research and Sci-Med had no more than bare legal title. Sci-Med's role, respondent contends, was purely that of a financing vehicle to inject capital into the venture.

Petitioners argue that Sci-Med's role with regard to the research and development venture was sufficient under Snow v. Commissioner, supra, and Cleveland v. Commissioner, supra, to qualify as being "in connection with [Sci-Med's] trade or business." Petitioners argue, further, that Green v. Commissioner, supra, on which respondent relies, is an incorrect interpretation of the law and is not controlling. Alternatively, petitioners contend that, even if Green v. Commissioner, supra, represents a correct interpretation of the law, the facts herein are distinguishable from those in Green. Finally, petitioners argue that the research and experimentation carried on by Teva was carried on Sci-Med's behalf within the meaning of section 1.174-2(a)(2), Income Tax Regs.

We think that respondent has the better of the argument.

It is clear that under Snow v. Commissioner, supra, the taxpayer may not currently be engaged in carrying on a trade or business in order for research or experimental expenditures to be deductible under section 174. However, the Supreme Court, in Snow, did not, and indeed could not, delete the requirement that the expenditures be paid or incurred as a result of research or experimentation undertaken by the taxpayer, or by another person or organization in the taxpayer's behalf, "in connection with [the taxpayer's] trade or business."

In Green v. Commissioner, supra, we stated that "For section 174 to apply, the taxpayer must still be engaged in a trade or business at some time * * *." 83 T.C. at 686. This is consistent with the congressional purpose of section 174 -- "to equalize the tax benefits of the ongoing companies and those that are upcoming and about to reach the market," 416 U.S. at 504. -- and does not operate to deny a deduction of research or experimental expenditures to "small businesses which are developing new products and do not have established research departments." See the statement of Congressman Daniel A. Reed of New York, Chairman of the House Committee on Ways and Means, appearing at 100 Cong. Rec. 3425 (1954), quoted in Snow v. Commissioner, 416 U.S. at 503. We accordingly reject petitioners' contention that Green is an incorrect interpretation of the law.

The fact that the agreement between Sci-Med and Teva was styled "exclusive license agreement," is not determinative of its legal consequences. L-R Heat Treating Co. v. Commissioner, 28 T.C. 894, 897 (1957); Leh v. Commissioner, 27 T.C. 892, 897 (1957), affd. 260 F.2d 489 (9th Cir. 1958).

Pursuant to the terms of the exclusive license agreement executed by Sci-Med and Teva, Sci-Med granted Teva the sole and exclusive worldwide license to manufacture and make sales or other dispositions throughout the world of products and to sublicense the license. The definition of products contained in the sub-research and development agreement was expressly incorporated. Thus, for purposes of the exclusive license agreement, products included any inventory or patents, applied for or granted, relating to both the general research area -- the development of new antibiotic drugs, including the synthesis of new drugs, as well as the extension of any drugs currently in existence -- and the specific research area -- the rational extension of beta-lactam antibiotics. Products also included patentable and nonpatentable inventions.

Sci-Med further granted Teva, under the provisions of the exclusive license agreement, the right to use the proprietary information "in its entirety." In this regard, Sci-Med was obligated to provide reasonable security measures to prevent unauthorized persons from obtaining any information, notes, records, data, plans, designs, or other documents constituting proprietary information. Sci-Med was not to divulge such knowledge; it was also not to permit any of its affiliates to perform any function or job in connection with products or to have access to the proprietary information.

We agree with respondent that the so-called exclusive license agreement effected a relinquishment, for consideration, of Sci-Med's proprietary interest and substantial rights in the results of the research and development venture.[14/] The terms of the said agreement are clear that Teva had the exclusive right to "manufacture and make sales or other dispositions throughout the world" of products, as therein defined, for the duration of the agreement. Pursuant to the terms of the handwritten agreement, the term of the said agreement was to be the later of: (1) 24 years from December 16, 1980; or (2) 15 years from the date of commercial exploitation of the products. In no event, however, was the term of the exclusive license agreement to extend beyond the year 2019. During the aforesaid term Sci-Med was also precluded from manufacturing, selling, or distributing products which might be regarded by Teva as directly competitive.

[14/] Such "rights" had been acquired by Sci-Med in the same set of agreements with Teva, on December 16, 1980. Thus, if Sci-Med ever was the owner, it was for a period of time less than the flicker of an eyelid. The economic reality and substance of the whole formalism of Sci-Med as an "owner" can be seriously questioned.

Since the exclusive license agreement was entered into by Sci-Med prior to the commencement of any research or experimental activities, Sci-Med was effectively precluded from ever having a substantial right in the results of the said activities, and from ever using the results of the research or experimental activities in connection with its own trade or business, present or future. Sci-Med's role was exclusively that of a financing vehicle, injecting risk capital into the venture. Its activities never, and could have never, surpassed those of an investor.

The management of investments is not a trade or business, irrespective of the extent of the investments or the amount of time required to perform the managerial functions. Higgins v. Commissioner, 312 U.S. 212 (1941); Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983); Purvis v. Commissioner, 530 F.2d 1332 (9th Cir. 1976), affg. per curiam T.C. Memo. 1974-164. A taxpayer who holds securities for long-term appreciation and who seeks current income from dividends and interest paid on such securities, rather than from frequent short-term trades, is an investor. Moller v. United States, 721 F.2d at 813; Purvis v. Commissioner, 530 F.2d at 1334; Liang v. Commissioner, 23 T.C. 1040, 1043 (1955). Sci-Med's "royalty" interest in the results of the research venture was analogous to that of an investor. Green v. Commissioner, 83 T.C. at 689. Thus, there were no possibilities that Sci-Med's expenditures could be "in connection with [its] trade or business," as required by section 174.

Petitioners argue that Sci-Med and Teva, the parties to the exclusive license agreement, intended that the development of the results of the research or experimentation into commercially exploitable products be a condition precedent to the effectiveness of the exclusive license agreement, and that Sci-Med did not relinquish its entire interest in the research or experimentation on the same day that it was acquired.

With respect to petitioners' contention that the development of commercially exploitable products was intended to be a condition precedent to the effectiveness of the exclusive license agreement, the existence or nonexistence of such intent may be, arguably, a material issue of fact requiring a trial. See Rule 121(d). As "evidence" of the existence of a factual issue regarding the intent of the parties to the license agreement, petitioners rely on: (1) Certain provisions contained in the sub-research and development agreement and in the exclusive license agreement; and (2) the affidavit of James Muskal, a patent attorney in Chicago, Illinois.

Looking first to the sub-research and development and the exclusive license agreements, petitioners point to the portions of recitals which state, respectively, as follows:

> Whereas, the Partnership [Sci-Med] has contemporaneously entered into an exclusive license agreement and option agreement with the Developer [Teva] providing inter alia for the grant of an exclusive license to the Developer to make, manufacture, use, and sell the Products, if any, developed in the R&D [research and development] Program * * *.

and

> Whereas, the Licensor [Sci-Med] has engaged the Licensee [Teva] to conduct a research and development program (the "R&D Program") pursuant to a Sub-Research and Development Agreement executed and delivered simultaneously herewith, for the purpose of developing certain products as defined below ("Products") * * *.
>
> Whereas, the Licensee desires to obtain the sole and exclusive license to make and manufacture and to use, sell and otherwise distribute Products throughout the world and in connection therewith to use the Proprietary Information, primarily by manufacturing for its own account in Israel; and
>
> Whereas, the Licensor is desirous of granting a license to the Licensee on the terms and conditions hereinafter described * * *.

Petitioners further point to the terms of the sub-research and development and the exclusive license agreements which state, respectively, as follows:

> A. Developer [Teva] agrees during the term of this Agreement to perform such research, experimentation and development services in accordance with this Agreement and the R&D Agreement in an effort to develop Products to be sold in commercial quantities for both medical and nonmedical uses. * * *

and

> A. Subject to the restrictions and obligations contained in the Program Agreements and as assigned in the Sub-Research and Development Agreement, the Licensor hereby grants the License to the Licensee for the consideration set forth in Paragraph 5A hereof and upon the additional terms and conditions hereinafter set forth. * * *

The above-quoted portions of the recitals and provisions of the aforesaid agreements are said to have a "common thread running through; that being the intent of the parties to make the conveyance under the License Agreement subject to the condition that there exist at some future time, a commercially viable product." (Emphasis added.)

The sub-research and development, and the exclusive license agreements, are before us. We find these agreements to be unambiguous and indicative of the intention of the parties that they be immediately effective. This is indicated both by the agreements, considered in their totality, as well as by the fact that the date of effectiveness of both agreements commenced on the same date, December 16, 1980, the date that the agreements were signed. Even assuming, arguendo, that the totality of the operative provisions of the agreements did not clearly express the parties' intentions, we find no support for petitioners' position in the quoted portions of the recitals and of the provisions thereof. The inescapable conclusion to be derived from the reading of the above-quoted language in the sub-research and development and the exclusive license agreements is that, upon the execution of the agreements, Teva received the rights to the products resulting from the research that was to be conducted by Teva. Concurrently therewith, Teva assumed the obligation to perform the research and development services agreed upon with the purpose of developing products. Since the license agreement purported to convey Sci-Med's interest in the research and development venture, a reference to the restrictions and obligations contained in the sub-research and development agreement, as well as to the research and development agreement between the OCS and Teva were necessary in order to clearly define the rights and relationships between all the parties concerned.

Petitioners contend that Mr. Muskal's affidavit establishes that a "research and development partnership is one recognized and well established format within the industry for raising venture capital for development of technologies and products," and that "in order to have a complete research and development arrangement that would attract sophisticated investors, there has to be an ultimate licensee or manufacturer willing and capable of commercializing the to-be-developed invention from the outset." We do not question the accuracy of Mr. Muskal's representations. However, the practices within a certain industry or field of endeavor are not determinative of the consequences of a transaction for Federal income tax purposes. In this regard, we are satisfied that section 174 as enacted by Congress and as interpreted by the Supreme Court in Snow v. Commissioner, supra, requires more than a purely passive investment.

Petitioners contend that since Sci-Med retained an interest in the results of the research and development to be performed by Teva, that interest being the proprietary information, Sci-Med did not convey the whole of its interest and substantial rights in the research to Teva.

We disagree. The license agreement granted Teva the exclusive right to use the proprietary information in its entirety for the term of the agreement. During the said term, Sci-Med was also to refrain from divulging such knowledge and to take affirmative security measures to prevent anyone from obtaining it. Pursuant to the terms of the option agreement, Teva was granted an irrevocable option to purchase all of Sci-Med's rights, title, and interest in the proprietary information. According to the provisions of the handwritten addendum to the agreements, the irrevocable option was coterminous with the exclusive license agreement. The term of Sci-Med itself was coterminous with that of the exclusive license agreement and the irrevocable option agreement. Should Teva decide to exercise the irrevocable option to acquire the naked legal title to the proprietary information, Sci-Med would be deprived of its last remaining vestige of ownership in the research. Since during the lifetime of the option Sci-Med could not use the proprietary information, there was no foreseeable possibility that Sci-Med would ever be using the proprietary information in connection with a trade or business, present or future. The isolated sale of the proprietary information could hardly be considered to be "in connection with a trade or business". Furthermore, at the time of the expiration of the terms of both the exclusive license agreement and the option agreement, Sci-Med itself would be terminated, since their life terms were coterminous.

Further, in support of their contention that Sci-Med did not convey substantially all the rights in the research to Teva, petitioners argue that Sci-Med retained the right to supervise, review, and direct the work of Teva. Petitioners point to portions of the sub-research and development agreement which provide as follows:

> In the event that Developer's [Teva's] reports on the R&D Program indicate that the specific project described in Appendix 3 [the rational extension of beta-lactam antibiotics] may not be economically justifiable, the Developer and the General Partner of the U.S. Partnership [Yuki] shall mutually agree to amend the R&D Program so as to substitute and undertake other specific projects within the scientific research area described in Appendix 3 * * * .
>
> *   *   *
>
> A. The General Partner [Yuki] of the U.S. Partnership [Elmer South], solely by its duly authorized representatives, being Mr. Alex Pinsky, or Dr. Amnon Rafael, and representatives of the Government [of Israel] shall be permitted access to the premises of Developer [Teva] at which the R&D Program shall be conducted, during normal business hours, for the purposes [sic] of monitoring the progress of the R&D Program.

Petitioners further point to provisions that required Teva to: (1) Keep complete records of all experiments performed during all phases of the research and development program, the results thereof, and such other documentation as the Israeli Government or the OCS may require. The aforesaid items were to be available to Sci-Med for inspection during business hours on weekdays; (2) make available copies of all the documentation provided to the Israeli Government relating to the research and development to Ikapharm at Teva's premises; and (3) confer with representatives of the partners of Sci-Med to explain the technical summaries or reports required to be delivered, under the provisions of the research agreement, to the Israeli Government and to the OCS. Finally, petitioners contend that Sci-Med's activities pursuant to those rights is a material issue of fact requiring a trial.

Contrary to petitioners' assertions, the aforementioned provisions did not invest Sci-Med with the power to supervise and direct Teva's work. Yuki, on behalf of Elmer South, and not Sci-Med, was, hopefully, to agree with Teva to undertake other specific projects within the scientific research area of the rational extension of beta-lactam antibiotics should Teva's reports indicate that the original project was economically unfeasible. Even assuming, arguendo, that the activities of the general partner of Sci-Med's limited partner could be attributed to Sci-Med, Yuki did not acquire any supervisory or regulatory powers over Teva as a result of this provision. When and if the research and development project undertaken by Teva was found to be economically unjustifiable, Yuki and Sci-Med would be in an equal position to decide what new project to undertake. They were to "mutually agree" to amend the research and development program. The remaining portions of the sub-research and development agreement were contained in a section styled "Access to Information." Under the above-quoted provision, the representatives of Yuki, the general partner of Sci-Med's limited partner, were given access to Teva's premises in order to "monitor" the "progress" of the research and development program. Again, even assuming that Yuki's right can be attributed to Sci-Med, the said provision afforded no more than a right to check or observe the progress being made in the research. Even under the most favorable light to petitioners, this hardly equals the power to control or modify Teva's work.

Teva was to keep full and complete records of the experiments performed during all phases of the research and development program and the results thereof and such other documentation as the Israeli Government or the OCS might require. In this regard, it is noteworthy that the sub-research and development agreement provided that:

> "the Developer [Teva] has contemporaneously herewith entered into a research and development agreement with the Government of Israel * * * to conduct the initial phase of the R&D initiated by Developer * * * and in respect thereof, report directly to the Office of the Chief Scientist of the Ministry of Industry, Trade and Tourism * * * . [Emphasis added.]

The confidential memorandum prepared in connection with the offering of limited partnership units in Elmer South further stated that interim financial reports had to be furnished to the OCS. Thus, although Sci-Med was to have access to those records and documentation, this access was, as stated in the sub-research and development agreement, "for [purposes of] inspection by the Partnership [Sci-Med]." Finally, representatives of Teva were to confer with representatives of the partners of Sci-Med [Ikapharm and Elmer South] in order to explain the technical summaries submitted to the Israeli Government and the OCS. This is self-explanatory, and did not confer upon Sci-Med control over Teva's work.

Petitioners contend that under Cleveland v. Commissioner, supra, they are entitled to deduct the claimed research or experimental expenditures. They claim that the oil activities of Elmer South and the research and development activity were so functionally interrelated as to be analogous to the factual situation in Cleveland.

In determining whether the research or experimental expenditures herein at issue are allowable under section 174, we look to Sci-Med. That -- as limited partner of Sci-Med, and pursuant to the provisions of Subchapter K -- there is a flow-through of income, gains, losses, deductions, or credits of Sci-Med to Elmer South does not make Elmer South the focus of our inquiry. Finally, as our analysis of Cleveland reflects, we do not interpret the opinion of the Fourth Circuit as saying that section 174 requires nothing more than a passive role as an investor in a research or experimentation venture in order to obtain a deduction under section 174. As we have discussed in extenso, *supra*, the management of personal investments cannot rise to the level of a trade or business, irrespective of their extent and of the amount of time devoted to them. Such a holding would seem to be in direct contravention of the statutory requirement that the expenditures be "in connection with [the taxpayer's] trade or business."

Because of our determination that the research or experimental expenditures here in issue were not incurred in connection with a trade or business of Sci-Med, it is unnecessary for us to determine whether such expenditures were incurred on Sci-Med's behalf within the meaning of section 1.174-2(a)(2), Income Tax Regs. We hold that petitioners are not entitled to deduct their distributive share of partnership losses attributable to the section 174 deduction claimed in 1980, and we accordingly grant respondent's motion for partial summary judgment.

An appropriate order
will be issued.